OVERSIGHT OF THE INTERNAL REVENUE SERVICE

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMENT AND INTERGOVERNMENTAL RELATIONS

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

APRIL 2, 2001

Serial No. 107–33

Printed for the use of the Committee on Government Reform

Available via the World Wide Web: http://www.gpo.gov/congress/house
http://www.house.gov/reform

U.S. GOVERNMENT PRINTING OFFICE

77–055 PDF WASHINGTON : 2001

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OVERSIGHT OF THE INTERNAL REVENUE SERVICE

MONDAY, APRIL 2, 2001

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMENT AND INTERGOVERNMENTAL RELATIONS,
COMMITTEE ON GOVERNMENT REFORM,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:01 p.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn and Putnam.

Staff present: J. Russell George, staff director and chief counsel; Dianne Guensberg, detailee; Bonnie Heald, director of communications; Earl Pierce, professional staff member; Matthew Ebert, policy advisor; Grant Newman, assistant to the subcommittee; Brian Hom, intern; Michelle Ash, minority counsel; Mark Stephenson, minority professional staff member; and Jean Gosa and Earley Green, minority assistant clerks.

Mr. HORN. This hearing of the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations will come to order.

We are here today to examine several management issues involving the Internal Revenue Service, the Agency charged with collecting nearly 95 percent of the Federal Government's annual revenue and enforcing the Nation's tax laws. Every April 15th, the Internal Revenue Service holds American taxpayers accountable for the accurate reporting of their tax liabilities. The Internal Revenue Service must be held equally accountable.

Many improvements have been made under the capable and distinguished leadership of Commissioner Charles Rossotti, who has substantially turned this service around. However, impressive challenges remain and must be resolved.

On Friday, the subcommittee reviewed the results of the General Accounting Office's audit of the Federal Government's fiscal year 2000 financial statements. Based on that report and the findings of agency auditors, this subcommittee released its report card, grading the 24 major Federal departments and agencies on their progress in improving their financial management.

The Internal Revenue Service, as part of the Department of the Treasury, did not receive an individual grade. However, for the first time, the Service, the Internal Revenue Service, received a clean audit opinion on its financial statements. That is certainly a step in the right direction. However, as the Comptroller General of the United States, Mr. David Walker, testified Friday, it is only the first step toward the governmentwide goal of providing accurate, timely financial information on a day-to-day basis.

Today we will examine the efforts of the IRS toward meeting that goal and its efforts to protect the security of its computer systems which contain personal information on every taxpayer in this Nation. In addition, we will review the agency's program to reorganize its management structure and to modernize its business systems.

We are pleased that the IRS has made progress not only in its financial statements, but also in its efforts to improve services to the taxpayers. However, several serious concerns remain in these and other areas, such as the Service's efforts to protect and modernize its computer systems. It is essential that taxpayers know that their tax files are private and secured from unlawful invasion.

According to the General Accounting Office, the IRS achieved a clean opinion on its financial statements through extremely dedicated efforts that required IRS personnel to work around serious deficiencies in order to develop reasonable numbers for a single date, September 30, 2000. Yet, as Office of Management and Budget Director Mitch Daniels testified Friday, such efforts are meaningless until reliable financial information can be generated on a daily, weekly, monthly, and quarterly basis.

A tremendous amount of money is being invested in modernizing the business systems of the IRS. However, the General Accounting Office has expressed reservations about the Service's ability to manage these acquisition projects on schedule and within budget.

Computer security procedures remain a significant concern. Last year, General Accounting Office investigators gained unauthorized access to the IRS' electronic filing system, which contained the tax records of more than 35 million people.

The Internal Revenue Service says it has now fixed that problem. But it is troubling that it was the General Accounting Office auditors, not the IRS, who discovered the problem. But in fact, the GAO audit found that the Agency did not have adequate procedures in place to detect these unauthorized intrusions. The IRS tells taxpayers that their transactions are safe and secure. What the agency failed to tell taxpayers who are filing returns electronically is that an intermediary company, or partner, such as a tax preparing company or financial software manufacturer, may be involved in the transaction.

At the moment, the Internal Revenue Service does not require these partners to meet minimum computer security standards such as encryption. Such minimal standards place taxpayers who file their returns electronically at risk of exposing their personal tax records to unauthorized viewers. In addition, the IRS inspector general is investigating allegations that employees are still illegally browsing and misusing the personal tax records of others.

Given these risks, how can the Internal Revenue Service expect to comply with the IRS Restructuring and Reform Act requirement that by 2007, 80 percent of all taxpayers will file their returns electronically?

We welcome our witnesses today who will discuss these issues: The Honorable Charles O. Rossotti, Commissioner of Internal Revenue; the Honorable Larry R. Levitan, chairman of the Internal Revenue Service Oversight Board; and Mr. Robert F. Dacey, Director of Information Security Issues for the U.S. General Accounting Office. We look forward to your testimony.

[The prepared statement of Hon. Stephen Horn follows:]

ONE HUNDRED SEVENTH CONGRESS

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"Oversight of the Internal Revenue Service"
Opening Statement
Chairman Stephen Horn
Subcommittee on Government Efficiency,
Financial Management and Intergovernmental Relations
April 2, 2001

A quorum being present, this hearing of the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations will come to order.

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The IRS tells taxpayers that their transactions are safe and secure. What the agency fails to tell taxpayers who are filing returns electronically is that an intermediary company, or "partner," such as a taxpreparing company or financial software manufacturer, may be involved in the transaction. At the moment, the Internal Revenue Service does not require these "partners" to meet minimum computer security standards, such as encryption. Such minimal standards place taxpayers who file their returns electronically at risk of exposing their personal tax records to unauthorized viewers. In addition, the IRS Inspector General is investigating allegations that employees are still illegally browsing and misusing the personal tax records of others.

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We look forward to your testimony.

Mr. HORN. I believe Mr. Putnam is here. And, Mr. Putnam, if you have an opening statement, please feel free to make it.

Mr. PUTNAM. Thank you, Mr. Chairman. I thank the panelists, particularly you, Mr. Commissioner. We appreciate you spending some time with us this afternoon. I'm looking forward to hearing the testimony of the panel and learning of the progress that has been made by the IRS in reforming the agency.

This is a monumental task that the IRS has ahead of them, and I feel it's important for Congress to not only monitor their progress but, more importantly, to be involved in the process so we are able to offer assistance where it may or may not be needed, which is sometimes the case.

It appears that the IRS has made significant strides toward making meaningful changes in how it operates since the passage of the 1998 Internal Revenue Service Restructuring and Reform Act.

Obviously, the greatest criticism of the IRS by the general public has been its lack of customer service and its abusive tactics in pursuing delinquent taxes. These are serious concerns. But many other problems, such as improving internal management and modernizing the IT structure in the agency are also important issues.

I have reviewed the Strategic Plan developed by the IRS and the Oversight Board and feel that they're on track in addressing the many challenges facing the IRS. The Strategic Plan demonstrates a clear understanding of the needs of the agency and offers sensible solutions to meeting those needs. I am particularly encouraged by the agency's commitment to improving its customer relations and the progress that has already been made in accomplishing that endeavor. I feel this is an important first step in altering the image of the Internal Revenue Service, assuming the plan is actually implemented.

It's relatively easy to write a plan that will fix the problems. Changing an agency's culture so that the plan will work is quite a different matter.

Finally, we in Congress must recognize that one cause of the problems between the IRS and the American people is the complexity of the Tax Code. I certainly believe that Congress should shoulder its share of the burden for that. The more complicated the tax laws are, the more mistakes, misunderstandings, and opportunities for the misapplication of its provisions there will be.

I thank the panel for taking the time to be here and testify. I look forward to hearing of your progress and learning how this committee and this Congress can be of assistance. I recognize that you have an unenviable task in government, and often you're whipsawed between the different whims of Congress and the needs of revenue collection for this government. And, I certainly recognize that, and appreciate it, and look forward to your comments.

Thank you. Thank you, Mr. Chairman.

Mr. HORN. I thank the gentleman. As most of you know, this is an investigating committee and we do ask all witnesses to take the oath. So if you will raise your right hands.

[Witnesses sworn.]

Mr. HORN. I note that nine—the clerk will get the names of the supporting cast. The actors we know. So, thank you very much.

And, our first presenter is the Honorable Charles O. Rossotti, Internal Revenue Service.

STATEMENTS OF CHARLES O. ROSSOTTI, COMMISSIONER, INTERNAL REVENUE SERVICE, ACCOMPANIED BY LAWRENCE W. ROGERS, ACTING CHIEF FINANCIAL OFFICER; ROBERT F. DACEY, DIRECTOR, INFORMATION SECURITY ISSUES, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY MICHAEL BROSTEK, DIRECTOR, TAX ADMINISTRATION ISSUES; RANDOLPH C. HITE, DIRECTOR, INFORMATION TECHNOLOGY; STEVEN J. SEBASTIAN, ACTING DIRECTOR, IRS FINANCIAL MANAGEMENT ISSUES; AND LARRY R. LEVITAN, CHAIRMAN, IRS OVERSIGHT BOARD

Mr. ROSSOTTI. Mr. Chairman and Mr. Putnam, last year when I came before you I said we had a clear direction for the IRS and had taken some important steps to improve the IRS. Now I think for the first time I can tell you that we have a more comprehensive, real plan, referred to by Mr. Putnam, that lays out how we will build on the foundation that we have already laid to make the IRS everything that we think the American public has a right to expect it to be.

On January 30, 2001, the IRS Oversight Board approved the IRS Strategic Plan. It follows closely the spirit and the letter of the Restructuring Act and reflects what we intend for the new and modernized IRS. This plan shows how the IRS can dramatically improve services to taxpayers, ensure fairness and compliance with our tax laws, and at the same time meet these goals while continuing to shrink in size relative to our economy. These are challenging objectives, but the most challenging part of it is that we must continue to administer the world's largest and most complex tax system while simultaneously reengineering and improving how the agency works at its most basic level.

In other words, we have to operate effectively and modernize at the same time. Our plan is based on recognizing the reality of this dual approach. So, we have strategies to improve performance over the next 2 years while modernizing the agency in the long run. In conjunction with our missions and goals, we developed 10 strategies. For each of these for 2001 and 2002 we define specific priorities and projects and assign responsibilities for carrying them out.

For example, the 2001 filing season demonstrates how we can build on positive trends in meeting taxpayer needs and broadening the use of electronic interactions, which are two of our strategies. With respect to electronic filing, so far this filing season our filing from individuals using their home computers is up 37 percent compared to last year and is almost equal to the 5 million done last year. Overall, including all kinds of electronic returns, we expect to receive about 35 million returns electronically this year.

There are reasons why we continue to get more returns electronically. In the 2001 filing season, for example, we added 23 additional forms to the e-filing program and we expect to roll out 38 more next year for the 2002 filing season. That means that we will have e-file eligibility for about 99.1 percent of all taxpayers by the end of next year, which was an important limitation previously.

On other electronic interactions, our Web site has received about 1.3 billion hits this year, and through February there has been about 103 million downloads, mostly of forms. And that's almost double the 51 million last year. That's a lot of people that don't have to make a trip to the Post Office.

We also just announced a couple of weeks ago that taxpayers who need an extension to file their returns—and you're allowed an automatic extension until August 15th—can now do that with a simple phone call. You'll get a confirmation. No paper is required.

For the small business taxpayer we have an exciting pilot program ongoing right now to test an Internet based application for businesses to file and pay Federal taxes online, especially payroll taxes. This new feature, which is called EFTPS online, allows businesses to enroll in the system and then to securely make Federal tax payments as well as to check their payment history over the Internet. Using this system they'll be also able to schedule future payments through the Internet and even cancel payments if necessary. For most small businesses this type of transaction is the most frequent interaction they have with the IRS.

Let me also stress that during the past year, with respect to our electronic filing programs, responding in part to weaknesses that were identified by GAO, as you noted in your statement, Mr. Chairman, as well as to our own security office's initiatives, we completed a comprehensive set of exchanges and upgrades to strengthen our security for the millions of electronically filed returns for this filing season.

In another area of services to taxpayers, we made steady progress this year in providing telephone services. A few years ago busy signals were our biggest problem. One year there were 400 million busy signals, which was more than there were calls obviously. That problem has been reduced to a minimal level of busy signals, under 4 percent. On getting through to the IRS for filing season through March 23rd we've answered 51½ million calls, which is 14 percent more than last year. For those taxpayers who wanted to talk in person to a customer services representative, they have gotten through 66 percent of the time so far this filing season compared to 61.4 last year. Now, that's still well below what we should be, which is probably around 90 percent as in the commercial sector, but it definitely represents progress.

Another one of our major strategies is to promote the effectiveness of our asset and information stewardship. This includes all aspects of financial management, as you noted in your opening, Mr. Chairman. I'm very pleased to point out that in fiscal 2000 the GAO provided for the first time a clean opinion on all of our financial statements. Larry Rogers, until recently our Chief Financial Officer, has accompanied me to answer any questions on this topic because I have a recusal on most of that. However, I will make a couple of comments on it since it's so important.

Very shortly after he came here, Secretary O'Neill said that "good stewardship of taxpayer resources is a responsibility I take very seriously." And I do, too. At the IRS we want to make sure that every manager and employee takes this responsibility very seriously.

During the last fiscal year, I think we demonstrated that seriousness by the tremendous amount of hard work, acknowledged by the GAO, of the IRS staff. They also identified where significant improvements were made to our internal systems and noted the management focus.

I also want to acknowledge, Mr. Chairman, that the work that was done to achieve this clean opinion was not only by the IRS, the GAO itself did a tremendous amount of work in a very constructive way to work with us to get this clean opinion, and we also note that your committee has made a continued emphasis on this area, which I think has certainly provided us an incentive and encouragement to come here. We prefer not to come here explaining why we didn't get a clean opinion, very honestly.

Mr. HORN. That's an honest witness who says he doesn't prefer to come here.

Mr. ROSSOTTI. I said we prefer not to come here when we have to explain why we didn't get a clean opinion. I think we're much more pleased to come under these circumstances. But we also recognize that we have a lot more to do, and we're already under way with our planning to talk about what we need to do to improve future audits and especially to address the material weaknesses that were still identified by GAO.

On the longer term, modernization, the other prong, if you will, of our efforts to improve the agency; we've made, we believe, steady progress in the three key modernization programs. In response to RRA 1998, we have the new customer-focused organization implemented for the most part and a total top management team in place for each of our four operating divisions, the functional units.

On another major effort we have also got now our balanced measure system in place for much of our new organization, and by the end of this fiscal year, we should have most of those measures deployed throughout our field organization. These changes, especially the organizational changes, are already enabling us to do one of the key things we want to do, which is to understand taxpayer needs better and to tailor our services as well as our compliance programs where they will do the most good.

Just to give two examples, we recently rolled out a specialized sub-sight on our Web site for the small business self-employed community. We have for large business two new issue resolution programs which are attempting to resolve issues more expeditiously and efficiently for large businesses.

The third and probably biggest, at least in terms of time and cost the biggest part of our modernization program, which is our business systems modernization program, officially kicked off with the first funding release almost exactly 21 months ago. This is still the early stages of this long-term program, but we believe we've made solid progress in a number of areas, three in particular. One is developing an agency wide vision and architecture; second, building a program management capability; and third, delivering on some near term specific business projects.

The enterprise architecture, which is essentially our road map for modernizing the agency's business systems as well as its supporting technology, was approved earlier this year. Our management capability, which involves using a rigorous methodology and governance process, is improving greatly, although it still has a ways to go before it's fully mature. Our first two projects, one to improve technology for our telephone services and the other to provide better tools for our employees who examine corporate income tax returns, will be rolled out over the next few months, which is approximately 2 years after the initial start of the program.

Now, Mr. Chairman, I have to say in spite of the progress we have made since the enactment of RRA 1998, I have to acknowledge that it is very clear that we are still not reaching the goals that we've set for ourselves. We are not providing the level and quality of services that we think taxpayers deserve, nor are we collecting all the taxes that are officially due.

I could give examples. I cited the improvement in the level of phone services. That's the glass is half full, the glass is half empty because it's not at the level that it needs to be, and it's certainly not comparable to the private sector. We're not satisfied with the quality of our phone services yet, even though it's improving.

Also, aside from the matter of whether taxpayers could get through because of the antiquated computer systems that our employees have to deal with, we often can't provide taxpayers with up-to-date information on their accounts, which results in considerable frustration both for our customers and our employees who want to help the taxpayers. Another sign of the problems we still have is that almost every business process operates too slowly, and, sometimes inaccurately and inefficiently.

In previous hearings, Mr. Chairman, you and I have discussed how slow and inefficient our collection process is, which depends—and I think you remember the chart. At one time I think you took it back to your office. I will be glad in the rest of this, if you want, to go into what we're doing about that because I think we're moving on that.

In terms of our communication with taxpayers, we send out over 100 million notices a year. Many of them are somewhat confusing to the taxpayers. While electronic filing is increasing significantly, it's going to be very difficult to reach 80 percent by 2007, which is the goal that Congress set for us.

As we noted, even though we got a clean opinion, we still have material weaknesses in our financial systems. Some of those we can address quickly through better management, but frankly, the most serious ones cannot be effectively addressed except through our business systems modernization program.

In addition, we're also deeply concerned about the continued drop in our audit and collection activity. The risks in these declines is not simply the dollar value of the taxes that are left uncollected. We think the greatest risk is that the average taxpayer who honestly pays his taxes loses confidence if the IRS fails to deal with and act efficiently and effectively to collect from those who do not pay what they owe.

The effect of decline in our examination coverage is especially important with respect to fairness since it's relatively easy for the IRS to verify most of the income of lower and middle income taxpayers, but, it's much harder and often requires an examination to verify the income of higher income and corporate taxpayers. This decline in activity up through the last 3 years was caused by several factors, including the long-term decline in staffing, the need to assign some compliance staff to customer services duties during the filing season, and the edit RRA responsibilities. With the help of money that was appropriated by Congress in 2001 as well as, very importantly, our new organization structure, which I think is better at focusing on what we want to accomplish, we hope to turn that around beginning this year.

With respect to the modernization program, business systems modernization is at a critical juncture. It will require continued financial support from the committees of Congress who oversee us. I am pleased to say that, as was noted in the President's blueprint announced a few weeks ago, the budget will include close to $400 million in investments for the information technology investment account.

So, Mr. Chairman, in conclusion, I hope I have given you a brief but balanced assessment of where we are at the IRS. I think we're on the right track. We, I think, have demonstrated our ability to make some short-term improvements in services, and to make essential organizational changes, and I think, very importantly, to produce a viable plan that will guide our efforts, which are aimed at making major changes in the entire way we do business in providing services to the taxpayers. With your continued support, and that of the American people, I am very convinced that we can succeed in this effort.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Rossotti follows:]

TESTIMONY OF
CHARLES O. ROSSOTTI
COMMISSIONER OF INTERNAL REVENUE
BEFORE THE
HOUSE GOVERNMENT REFORM
SUBCOMMITTEE ON GOVERNMENT EFFICIENCY, FINANCIAL MANAGEMNET, AND INTERGOVERNMENTAL RELATIONS
FILING SEASON, BUDGET, AND FINANCIAL AUDIT
APRIL 2, 2001

Mr. Chairman and Distinguished Members of the Subcommittee, I am pleased to discuss the IRS' 2001 tax filing season, our FY 2002 budget request and the initiatives we are undertaking on behalf of America's taxpayers.

INTRODUCTION: A PLAN FOR TODAY AND THE FUTURE

Mr. Chairman, last year when I came before you, I said we had a clear direction and had taken some important steps to improve the IRS. Now, for the first time I can tell you that we have a real plan that lays out how we will build on the foundation we have laid to make the IRS everything the American public has a right to expect it to be.

On January 30, 2001, the IRS Oversight Board approved the IRS Strategic Plan. It follows closely the letter and spirit of the IRS Restructuring and Reform Act of 1998 (RRA 98) and reflects the new and modernized IRS. The strategic plan shows how the IRS can dramatically improve service to taxpayers and ensure fairness and compliance with our tax laws. Moreover, the Agency will meet these goals while continuing to shrink in size relative to the economy.

The greatest challenge presented by the IRS strategic plan is that we must continue to administer the world's largest and most complex tax system while simultaneously reengineering and improving how the Agency works at its most basic level. In other words, we must operate effectively and modernize at the same time.

Mr. Chairman, I want to emphasize the importance of this two-pronged, or dual approach of strategies to improve performance over the next two years while modernizing the Agency in the longer term. Let me illustrate how this approach is now working. In conjunction with our mission and goals, we developed 10 major strategies. For each of these strategies, operational priorities and improvement projects for FY 2001 and 2002 were defined and responsibilities assigned for carrying them out. Some of our major strategies include:

> ***Meet the Needs of Taxpayers.*** Each year, the IRS has millions of interactions with taxpayers who need information or assistance to file their returns or pay what they owe. The taxpayer should always receive quality service from the IRS that is helpful based on his/her particular situation and need. Taken together, the fundamental changes underway in all aspects of our operations will provide taxpayers accurate and

prompt information to assist them in filing, paying, and resolving issues in a time and manner convenient for them. In the short-term, we will implement this strategy through actions such as expanding phone-hours, adding more convenient locations and providing additional assistors during peak hours.

Reduce taxpayer burden. One of the themes underlying improved IRS's business practices is to shift from addressing taxpayer problems well after returns are filed to addressing them early in the process, and in fact preventing problems wherever possible. Over the next two years, we will make substantial progress to reduce taxpayer burden although much more will be possible through our longer-term business system modernization efforts. Increasing our partnerships with states and practitioners will be a major part of this strategy. In the short-term, we can make improvements, such as expanding our Voluntary Compliance Agreement Program and providing specific information over the Internet to taxpayers groups. The new IRS "Small Business Self-Employed Community" web page is an excellent example of this strategy.

Broaden the use of electronic interactions. Electronically-filed returns improve service for taxpayers and boost productivity by reducing errors, speeding refunds, and reducing labor costs. We will enhance technology to allow filing of a full range of returns, eliminate requirements for separate signature documents, tailor marketing and education programs to attract taxpayers and practitioners with varying needs, and broaden the number of payment options. Customer education and assistance programs provided through the IRS web site, such as the distribution of forms and publications and answers to tax law questions, are growing rapidly. We are making excellent short-term progress on this strategy. Examples include the elimination of paper signatures for *e*-filed returns and dramatically increasing the number of forms that can be filed electronically.

Address key areas of non-compliance. Research indicates that there are major non-compliance problem areas. These include abusive tax shelters and trusts as vehicles for managing assets and for wealth transference. Unpaid employment and withholding taxes by businesses have also increased and overpayment of refunds due to erroneous return claims is high. We will make progress in combating key areas of noncompliance over the next two years as demonstrated by our recent actions on illegal offshore trust programs. In 2002, the IRS will change its processing procedures and begin processing and matching K-1s (schedules filed by partnerships, trusts and S-corporations to provide information on income/losses distributed by business entities, to individual partners, beneficiaries and shareholders).

Stabilize traditional non-compliance areas. Regardless of how successful we are in preventing taxpayer errors, intervention through examination and collection actions and investigations is necessary when noncompliance or non-payment is found or suspected to be occurring. Since we have limited resources, it is essential that we apply these resources where they will be of most value. More focused and rapid intervention can enormously improve the effectiveness and efficiency of our activities, while improved case management tools can improve the quality and speed of cases and ensure that taxpayer rights are observed. The recent funding of the STABLE (Staffing Tax Administration for Balance and Equity) initiative is key to the IRS stemming and turning around the decline in collection and exam activities.

These major compliance improvements will require, however, a fundamental redesign of our most complex business processes. They are also very dependent on new technology from our Business Systems Modernization program (BSM). Therefore, our strategy is to stabilize and improve traditional compliance programs in the near term, while working through BSM for long-term and fundamental improvements.

Over the past year, the IRS also made steady progress on three key modernization programs. In response to RRA 98, the new customer-focused organization is currently being implemented, and a top management team is in place for each of the four Operating Divisions and functional units. We also approved balanced measures for much of the new organization and have slated approval of measure for the remaining organizational units for the current fiscal year. Both of these programs should start delivering benefits now.

The third piece of modernization, the Business Systems Modernization program (BSM) is off to an excellent start. The Enterprise Architecture plan, which is the roadmap for modernizing the Agency's business systems and supporting information technology networks, was approved earlier this year. BSM is just beginning to deliver tangible improvements; it will deliver a growing number of benefits with each succeeding year for the remainder of the decade. Each of these programs is discussed in detail later in the testimony.

Mr. Chairman, I want to stress that this dual approach will require sustained support from the Congress and the public, as the change will take time and will inevitably include setbacks along the way. It will also require investments, especially for business systems modernization, and adequate funding for current operations, such as customer service and compliance.

PROGRESS MADE: INITIAL SUCCESSES UPON WHICH TO BUILD

Mr. Chairman, I would like to discuss some of the progress the IRS has made over the past year, particularly as it relates to how we are making it easier for all taxpayers to file their returns and pay their taxes and how we are ensuring the fairness of our tax administration system.

Checkbox Initiative

Beginning this filing season, Paid Return Preparers can use the Third Party Authorization Checkbox on all Form 1040 Series returns with the exception of TeleFile. This checkbox indicates the taxpayer's desire to allow the IRS to discuss the tax return and attachments with the preparer while the return is being processed. This provides for a significant reduction in paperwork for millions of taxpayers. It also addresses a problem with which we have been grappling for years.

Including a checkbox on the family of 1040 returns is a direct response to requests from our external stakeholders, such as the South Florida Citizen Advocacy Panel (CAP), National Society of Accountants, National Association of Tax Practitioners and National Association of Enrolled Agents.

The checkbox designation should enable practitioners quickly to resolve questions concerning the processing of the taxpayer's return. It should also reduce the number of contacts necessary to resolve processing questions and eliminate the need for the submission of paperwork for a Power of Attorney, which is not required to resolve simple problems with a taxpayer's account. Our initiative also addresses the practitioner groups' concern that this designee not be afforded post-assessment correspondence or representation.

Mr. Chairman, the IRS calculates that taxpayers will save an estimated 75,000 hours initially by not having to prepare a third party authorization disclosure form (Form 8821). Additional time will be saved because processing issues will be resolved immediately, thereby eliminating unnecessary post-filing contacts. However, we recognize that the net burden reduction, as currently calculated, will be somewhat smaller because there will be an increase in burden for reading and understanding Forms 1040 instructions for the new checkbox authority.

We further expect over a million taxpayers to use the checkbox feature in lieu of filing Form 2848 (Power of Attorney and Declaration of Representative). Therefore, taxpayers will save an estimated 1.9 million hours initially by not having to prepare Form 2848. Once again, the net burden reduction will be less because we must assume there will be an increase in the burden for reading Forms1040 instructions and understanding the new checkbox authority.

The burden reduction that will result from the checkbox initiative is even greater when one considers the 8 million notices related to math errors and return preparation that were issued in 2000. Twenty-seven percent of these notices were related to returns prepared by paid preparers. The IRS estimates that taxpayers will save approximately 779 thousand hours by referring notices to their designees rather than responding to the IRS in writing or by telephone. Similarly, we estimate that taxpayers will save more than a million hours related to correspondence by allowing IRS to resolve issues by contacting their designees.

Redesigned Notices

As part of its continued effort to improve its correspondence to taxpayers, the IRS began sending out six redesigned notices, including those dealing with math errors, balance due, overpayments and offsets. The new notices should: (1) reduce the number of times taxpayers need to contact the IRS; (2) be easier to understand; and (3) facilitate resolution of inquiries. The combined yearly volume of these six notices is about 10.5 million.

Following RRA 98's directions, the new notices also contain more information, including: (1) the formula for how the IRS computes the penalty or interest; (2) the section of law from which the penalty or interest is based; and (3) a table that details account information under each penalty or interest section to specific periods that the charges apply. Members of the Citizen's Advocacy Panel reviewed the notices before we released them in October 2000.

Despite extensive testing, some of the first notices sent out were missing information. The IRS has since corrected errors in the programming for these notices and mailed explanations to taxpayers as appropriate.

We are continuing our redesign efforts on 23 additional notices. We plan to release four of the notices in 2002 and the remaining 19 in 2003.

Change of Address

Due to a licensing agreement between the IRS and the U.S. Postal Service, taxpayers who move after filing their tax returns should receive future correspondence from the IRS on a more timely basis.

Under this arrangement, the IRS will use the Postal Service's National Change of Address (NCOA) database to update the addresses in its own Master File of taxpayer data. This address updating process should also provide quicker resolution of undelivered refund problems.

The IRS will check the names and old addresses in the NCOA weekly update files against the names and addresses in the IRS database. Where there is an exact match, the IRS will update its file with the taxpayer's new address. According to the Postal Service, there are about 800,000 address changes each week.

In addition to helping IRS get refunds to taxpayers, this new program will permit the IRS to make earlier contacts with them to resolve issues such as delivery of a returned refund, possible unreported income, examination of a return, or collection of unpaid tax. The delay in delivery that can result from a letter going to an old address, then being forwarded, may cause a taxpayer's reply and a subsequent IRS letter to cross in the mail. Unraveling such situations can be time-consuming and frustrating for both the taxpayer and the IRS.

Stabilization of Compliance Activities

Earlier this year, Congress approved the staffing plan for the STABLE (Staffing Tax Administration for Balance and Equity) initiative. The funding was included in the Fiscal 2001 Appropriations bills.

The STABLE staffing plan reflects the new modernized IRS and represents a careful judgment as to how these additional resources, together with our internal management improvements, can best be used to improve our service to taxpayers and compliance effectiveness.

The two principles that guided the budget request were, first, allocate incremental resources directly to staffing front line positions. Second, these additional resources will provide a balanced improvement between service and compliance programs. With the increased staffing levels, we expect the IRS to be able to slightly increase levels of service and to stabilize the level of exam and collection activity while complying with the taxpayer rights provisions of the RRA.

Our overarching goal is to achieve the greatest possible improvements in both taxpayer service and compliance efforts by determining how best to use the STABLE resources in conjunction with the base FY 2001 budget request. We believe that STABLE achieves this goal.

In our reorganization effort over the last two years, we have carefully studied the use of nearly every position in the IRS. One of the key findings in this analysis is that the use of compliance personnel such as revenue agents and revenue officers on "details" to taxpayer service duties during the filing season is not efficient. This practice, while necessary as a short term solution to inadequate service, takes highly trained and high graded personnel away from important exam and collection casework during a substantial part of the year, causing reduced levels of productivity and delays in completing cases.

Another key finding of the study is that the IRS provided very minimal levels of activity in assisting taxpayers to understand their tax obligations and avoid mistakes in filing, especially in the small business areas. Many stakeholders groups have stressed that this problem causes errors later in the process, which are expensive for both taxpayers and the IRS.

In our new structure, instead of increasing the number of expensive and scarce compliance personnel, we have provided for additional positions in taxpayer service and education. A significant portion of the STABLE resources will be used to fill these positions. By hiring staff to perform these service and educational functions, we can avoid the need to use more expensive compliance personnel on details during the filing season, thus allowing us to accomplish two objectives efficiently: increase our level of taxpayer education and taxpayer service and increase the number of staff years actually applied to exam and collection casework.

With this approach to the STABLE staffing, together with our reorganization and technology improvements, we expect to show measurable improvements in our key programs in FY 2001. Because of the time required to hire and train people, we will not achieve the full impact until FY 2002. Some of the improvements we expect in key areas in FY 2001 are:

- Increase the level of service on our toll free telephone service from approximately 59.1 percent in FY 2000 to approximately 63.4 percent in FY 2001, while also improving our quality measures.

- Reverse the downtrend of the last five years in compliance, increasing the number of overdue accounts closed by our telephone and field collectors by 8.6 percent.

- Increasing the number of exams of individuals conducted in person by about 6.2 percent, while also improving quality.

In examination, we will focus on the areas with the greatest risk of underreporting of income. For example, the number of exams of higher income individuals and corporations will increase more rapidly than the average.

This additional staffing will allow us more quickly to resolve innocent spouse claims, offers in compromise cases and collection due process cases we completed – key taxpayer rights included in RRA 98. We will also increase our commitment to pre-filing assistance to taxpayers through communication and education programs and pre-filing agreement programs. These areas are of particular importance and concern for the small business community.

Targeting Our Resources

We must promote fairness by combating key areas of non-compliance. To this end, the IRS must apply its limited resources where they will be of the most value. Some of the special problem compliance areas include: underreporting, non-filing and abuse of trusts and passthroughs; abusive corporate tax shelters; accumulations of unpaid trust fund taxes; and erroneous refund claims.

Abusive corporate tax shelters continue to be an important compliance initiative for the IRS. From the information that IRS and Treasury receives from a variety of internal and external sources, we know that there are a significant number of transactions that have no legitimate business or economic purpose other than reducing taxes.

These abusive corporate tax shelters could seriously undermine the tax system if all corporations believe they must engage in these transactions to keep up with the competition.

We have a coordinated effort with Treasury to deal with this problem and our Office of Tax Shelter Analysis (OTSA) plays an important role in it. The IRS does not want to impede normal tax planning, and through the OTSA, we have available a means to separate the real problems from quite legitimate transactions. In addition, a "Tax Shelter Hotline" and our commitment to issue more guidance in this area will help us respond to abusive transactions on a more timely basis.

Promoters of abusive tax shelters are also using offshore tax entities in their tax schemes to unlawfully reduce or eliminate taxes. Last month, in the largest IRS enforcement action ever taken, law enforcement authorities in multiple states executed over three dozen search warrants and made four arrests as part of a series of investigations of alleged illegal offshore trust programs involving the diversion of millions of dollars of income for hundreds of clients.

I want once again to express my appreciation for the fine work done by our Criminal Investigation Division, the United States Attorneys offices in Boston and San Francisco, the Tax Division of the Department of Justice, and the Costa Rican law enforcement authorities. Last month's historic enforcement activities send an unmistakable signal about IRS' commitment to pursue investigations of promoters and their clients who would try to move money off-shore to evade taxes.

It further represents the IRS' continuing efforts to combat tax compliance problems caused by those who promote and participate in the use of trusts and offshore schemes designed to evade U.S. taxes.

Frauds Alerts: Buyer Beware

In February 2001, The Internal Revenue Service issued a nationwide alert to taxpayers, warning them not to fall victim to a number of tax scams that are being promoted. These schemes take several shapes, ranging from promises of special tax refunds to illegal ways of "untaxing" yourself. Taxpayers were told that they could report suspected tax fraud to the IRS by calling 1-800-829-0433.

One of these illegal tax schemes involves telling employers that they do not have to withhold federal income tax or employment taxes from the wages paid to their employees. Using a bogus interpretation of the Tax Code, the con artists are selling the unsuspecting and the unscrupulous a phony and illegal scheme that in the long run will cost these employers a huge tax bill that can include stiff penalties and jail time.

In addition to this warning, the IRS devoted a special consumer alert to this problem. We told working men and women that if they have concerns that their employer is failing to withhold these taxes to call our toll-free number at 1-800-829-1040. We are also asking our stakeholder groups to help us get the word out about this problem.

Taxpayers can get more information on how the IRS is combating this bogus withholding scheme by going to our web site at www.irs.gov and clicking on the "Small Business and Self Employed Community" page. From there, taxpayers can click on "tax schemes" and get all the necessary information. Taxpayers can also link to the IRS' Criminal Investigation home page and get a very detailed description of its employment tax enforcement program, including a breakdown of cases and a number of significant convictions of those who thought they could get away with evading their tax responsibilities.

I want to stress that IRS Criminal Investigation works closely with all parts of the Agency to investigate and refer for prosecution individuals and companies who have willfully failed to file or pay employment taxes. In the past three years, 127 individuals were sent to federal prison, a halfway house or home detention on employment tax issues. Nearly 86 percent of those sentenced for evading employment taxes served an average of 17 months in confinement and were ordered to make restitution to the government for the taxes evaded plus interest and penalties.

Revenue Protection Strategy

The IRS revenue protection efforts in 2001 will again identify and look at certain tax returns before issuing refunds. In addition to identifying questionable refunds, the IRS will continue its emphasis on improving compliance with the Earned Income Tax Credit (EITC) provisions of the Internal Revenue Code, including the use of our dependent database to identify questionable issues relating to incorrect claims on dependent exemptions, filing status and EITC credits.

The Earned Income Tax Credit Preparer Outreach Program will also continue. As part of this program, IRS revenue agents will visit tax professionals nationwide prior to January 2001, to provide individual assistance and to answer any questions about EITC. Some of the visits will also include a review of files to determine if due diligence requirements for the preparation of EITC have been met.

2001 Filing Season

The IRS is delivering a very successful filing season as it continues to meet the mandates that Congress set forth in RRA 98 and the challenges of modernization.

By continually managing this change and risk in an orderly and integrated fashion, I am pleased to report that as we approach the home stretch, the 2001 tax filing season has been smooth and almost error free. The 2001 filing season continues to demonstrate how we can build on positive trends in service to taxpayers, especially as our major technology and organizational initiatives take effect.

Projected net collections for FY 2001 will exceed the $1.9 trillion collected last year. During FY 2001, we also project to receive 215.4 million returns, including over 130.3 million individual returns, and expect to issue over 96.8 million individual refunds. As of March 9, 2001, the average dollar amount per refund is up over 5 percent over last year, and the average refund is $1,823.

Electronic Tax Administration

Mr. Chairman, RRA 98 mandated that at least 80 percent of returns be filed electronically by 2007. Reaching this and the other Electronic Tax Administration (ETA) goals is an enormous challenge, but well worth the effort.

The IRS' overarching goal is to conduct most of its internal and external transactions by electronic means. To meet this objective, we must make it not only technologically possible, but also attractive to the public to make a permanent change from paper to electronic means. Indeed, a robust ETA system helps form the foundation of a modernized IRS. It is key to easing taxpayer burden and can provide multiple benefits to taxpayers, practitioners and our tax administration system.

Let me also stress that during the past year, the IRS completed a sweeping set of changes and upgrades to add an extra layer of protection for the millions of taxpayers using the *e*-file program. We have strengthened our system's security and we will remain vigilant to keep our *e*-filing processes the safest possible.

The 2001 filing season statistics continue to demonstrate that an increasing number of taxpayers are taking the advantage of these initiatives and filing taxes electronically. Through March 15, 2001, over 29.3 million individual taxpayers filed using one of the three *e-file* options; a 10 percent increase over the same period last year.

- Nearly 21.7 million taxpayers *e-filed* their tax returns electronically through an IRS-authorized Electronic Return Originator (ERO), an 11.2 percent increase over the same period last year.

- Approximately 4.2 million taxpayers filed their tax returns on-line via their home computer through a third party transmitter. On-line filing is running 37 percent ahead of last year and as of March 15, is already approaching the 2000 total volume of 5 million.

- Almost 3.5 million taxpayers filed their returns over the telephone using the award winning TeleFile system. Oklahoma and Georgia joined Kentucky and Indiana in the Federal/State TeleFile option.

- Overall, 11 million taxpayers chose to file both their federal and state tax returns simultaneously in a single electronic transmission. This year, 35 states and the District of Columbia are participating in the program.

Mr. Chairman, let me also note that paper and electronic return preparation and filing are also offered through IRS local offices as well as Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites. Taxpayers who cannot afford either to pay a professional tax preparer or buy a personal computer and tax software may also go to local IRS offices to have their returns prepared. The tax software we use in our offices is competitively procured in the open market. Through this method, the IRS both electronically prepares and files simpler returns for lower-income taxpayers at their request.

New in ETA for the 2001 Filing Season

In order to improve our ETA program and ease taxpayer burden, the IRS listened to taxpayers, industry and practitioners. We heard that we must make electronic filing more attractive and remove barriers. Let me briefly discuss our efforts this filing season to meet these concerns.

First, the IRS is working to address the frustration that taxpayers and practitioners experience when they find they cannot file some forms electronically. For the 2001 filing season, we added 23 additional forms to the 1040-*e-file* program. These include Form 2106-EZ for un-reimbursed employee business expenses; the Form 2688 application for additional extension of time to file; and Form 8379 for injured spouse claims.

We plan to roll out the remaining 38 forms and schedules for the 2002 filing season. This means we will open *e-file* eligibility to 99.1 percent of all taxpayers, potentially adding 3.8 million new *e-filers* to the growing rolls. Equally important, it means that preparers will be able to go essentially 100 percent electronic for all of their customers by 2002.

Second, the IRS is making electronic filing paperless by eliminating the requirement for a separate paper document with the *e-file* return. In 2000, the IRS successfully tested the use of a Personal Identification Number (PIN) code as the taxpayer's signature, eliminating the need to file the paper *jurat*. This year's program extended the option to taxpayers nationwide, with some exceptions, and permits them to select a PIN, and then file electronically without any paper. So far, 4 million taxpayers have chosen this option.

Third, this filing season, more electronic payments options have been made available to taxpayers, such as accepting debit payments through TeleFile and accepting credit cards for Forms 1040ES, estimated tax payments, and Forms 4868, extensions of time to file. As of March 10th, 22,718 payments averaging $3,177 were made via credit card and another 24,064 payments averaging $1,026 were made by Automated Clearing House (ACH) Direct Debit where taxpayers can authorize either their checking or savings account to be debited.

Fourth, our e-Services project under BSM will help us conduct most transactions with taxpayers and their representatives in an electronic format. By 2002, the e-Services' goals are to: (1) provide the capability to register new electronic return originators over the Internet; (2) permit delivery of transcripts to authorized parties electronically; and (3) allow third parties who are required to provide certain forms 1099 and information returns to check the taxpayer identification numbers for accuracy before submission.

Fifth, contributing to this year's successful *e*-filing season is IRS' new marketing campaign, "40 Million People Already Know *e-file* is the Way to Go." In conjunction with its advertising agency, and as authorized by RRA 98, the IRS developed a fully integrated campaign with TV, radio and print advertising. As the *e-file* program matures, our data- and market-driven marketing campaign is shifting away from merely promoting awareness of *e-file* to emphasizing its value, such as saving taxpayers time.

ETA Also Easing Business Taxpayer Burden in 2001

A strong ETA program must embrace the needs and expectations of all taxpayers, including business taxpayers. In 2001, the IRS continues to make progress serving the electronic tax administration needs of this important sector.

For example, beginning last April, employers could file their Form 941 on line, saving time and paperwork. And for the first time, companies and payroll service provider will be able to file both the Quarterly 941 and Annual 940 (*Employer's Annual Federal Unemployment Tax Record*) electronically. A direct debit payment was also made available through Form 941 TeleFile

Another major ETA initiative eases the information-reporting burden for employers. Providers of certain information statements, including W-2s, now have the option of giving taxpayers the information electronically, instead of on paper.

These new rules were a direct response to requests we received from lenders, educational institutions, employers and stakeholders who wanted the option to deliver these statements in an electronic format. Under the new option, providers will save the cost of processing, printing and mailing paper statements. And recipients will receive the information faster and more efficiently without the worry of mailing delays or lost statements.

The Electronic Federal Tax Payment System (EFTPS) also continues to be a runaway success. In 2000, EFTPS topped all of its 1999 numbers for new enrollments, dollars and transactions. It processed more than 63 million federal tax payments – a 14 percent increase over the previous year year. And EFTPS also received a staggering $1.5 trillion – a 15 percent increase over the previous year. Payroll companies, tax practitioners and financial institutions have been instrumental in helping us grow this program and the use of electronic payments.

Why has EFTPS been so successful? Over the years, EFTPS has delivered a high level of service and accuracy. It consistently exceeds industry standards, and delivers a 99.9 percent accuracy rate for payments appropriately applied.

We developed the system with a focus on being able to handle significant volume with accuracy, integrating checks and balances to make sure information is correct and verified at each step of the process. EFTPS delivers a level of precision that can be compared to stringent banking and financial transaction standards for accuracy.

This year, we are conducting an exciting new pilot program to test our new Internet-based application for businesses to pay federal taxes on line. This new feature, EFTPS-OnLine, allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. Using EFTPS-OnLine, businesses will be able to schedule future payments through the Internet and cancel payments if necessary. They will also have access to on-line help and "how-to" pages with step-by-step instructions.

One of our primary EFTPS priorities is security and it continues with our new Internet feature. EFTPS-OnLine uses the strongest available security and encryption technology to ensure taxpayer privacy and protection. After evaluating the pilot results, we plan to make EFTPS-OnLine available to all business taxpayers and to individuals taxpayers who are required to make estimated quarterly payments.

There are currently more than 3 million taxpayers enrolled in EFTPS and with the addition of the new Internet feature, we expect that number to continue to grow.

Web-Based Help

The Internet continues to offer exciting new opportunities for easing taxpayer burden and improving service. The IRS web site, the *Digital Daily (www.irs.gov)*, has already received almost 1.3 billion hits this fiscal year. According to the "Lycos 50", since almost the beginning of the year, the IRS has consistently ranked among the top 10 user searches. As of March 21, 2000, it came in as Number 6.

Anyone with Internet access can receive: tax forms, instructions, and publications; the latest tax information and tax law changes; tax tables and rate schedules; and hypertext versions of all taxpayer information publications, including the very popular Publication 17, "Your Federal Income Tax"; all TeleTax topics; answers to the most frequently asked tax questions; a library of tax regulations; and the weekly Internal Revenue Bulletin that contains all the latest revenue rulings, revenue procedures, notices, announcements, proposed regulations and final regulations. However, to ensure that taxpayer privacy is protected, our web site will not provide or receive individual taxpayer data until adequate safeguards are in place.

Since coming on line in January 1996, taxpayers have downloaded over 412.9 million forms, publications and products. Through February 2001, there have been over 103 million downloads as compared to 51.5 million for the same period in 2000 – an increase of almost 100 percent.

The IRS web site also has a W-4 Calculator in its "Tax Info for You" section. In addition, the expanded use of online customer service technologies provides greater taxpayer access to IRS' help while on the *Digital Daily*.

Earlier this year, the IRS launched its new user-friendly "Small Business and Self-Employed Community" web page that can be accessed from our web site. It was developed by our Small Business/Self-Employed Operating Division specifically to benefit the millions of small business owners, the self-employed and start-up businesses who often confront more complex tax issues than taxpayers who have their taxes withheld by an employer.

This convenient "one-stop shopping" for assistance can provide most, if not all, of the immediate products and services that a small businessperson needs, such as a section on common problems, a calendar of important tax deadlines, helpful tax hints, forms and publications and a direct link to stakeholder sites, such as the National Association of Home Builders and the National Restaurant Association.

I mention these two associations because for the first time ever, the IRS is providing industry-specific tax information for the construction and restaurant industries. For example, if a food server wants to know the deadline for reporting tips, he or she can go to our site and in two clicks, learn that Form 4070 should be filled out and turned into the employer by February 12th.

In the near future, we will add more of these targeted areas to the web site, such as for the automotive and oil and gas industries. We will also add a Smart Q&A Wizard that will make it easier for taxpayers to search our growing database of frequently asked questions and get the information they need.

The IRS web site will continue to evolve and improve in design, content and features. The biggest leap in the future will be from its current state as an information source to include a transactional-based portal.

CD-ROMs

The Federal Tax Forms CD-ROM contains more than 600 tax forms and instructions for the current tax year, an archive of forms and instructions dating back to 1992 and some 3,000 pages of topic-oriented tax information. Users can electronically search, view-on-screen, or print any of the items contained on the CDs. The two-issue subscription is conveniently available through the *Digital Daily* for $21. If ordered by fax, mail, or telephone, the cost is $26 (includes postage and handling).

In conjunction with the Small Business Administration, the IRS also produced the latest edition of the joint small business CD-ROM, "Small Business Resource Guide: What You Need to Know About Taxes and Other Topics." It has consistently received highly favorable reviews from small businesses and external stakeholders. The Year 2001 version of the CD-ROM is being made available free of charge, one-per-customer, by calling our toll-free number at 1-800-TAX-FORM. It can also be ordered on the IRS web site.

The CD-ROM provides an array of helpful information for business operators, including actions to take before going into business and tax filing and reporting responsibilities when starting, expanding, closing and selling a business. In addition, it includes all of the business tax forms, publications and instructions for *e-filing*. The CD-ROM also allows users with Internet access to link to other helpful federal and state web sites.

Telephone Assistance

Throughout the 2001 filing season, the IRS will provide telephone assistance 24 hours a day/7 days a week at 1-800-829-1040. After April 16, we continue to offer around-the-clock service for refund and account callers, and service will be available for tax law assistance Monday through Saturday from 7:00 AM until 11 PM.

For the filing season through March 9, approximately 65 percent of the taxpayers who wanted to talk to a customer service representative got through, compared to 61.7 percent last year at this time. In addition, 10.5 million of taxpayers used our automated services to get information such as refund status, an increase of 132 percent since last year, and the trend has been upward. In the last four weeks, the level of service averaged 68.9 percent. The upward trend in phone service is encouraging and shows that our investments in training, management and technology are beginning to pay dividends. However, I concur with Treasury Secretary O'Neill's characterization of IRS's current level of phone service as "unacceptable." We still have along way to go before we can be satisfied with the quality of our phone service.

The IRS will continue to implement many process and systems enhancements to improve both the convenience and the quality of telephone communications. These changes are major, affecting approximately 14,000-15,000 employees in more than 20 locations around the country. With the benefit of new call routing technology and new software planning tools, we are realigning the work assignments and training of many of these assistors so that the employees will have the right specialized training and knowledge to answer taxpayers inquiries efficiently and accurately. We will make increasing use of the technology to direct taxpayer call more accurately to the right assistor, and enable taxpayers in many cases to make uses of "self-service" applications, either through the phone or the Internet.

As these changes take place, the average complexity of calls answered by the Customer Service Representatives (CSRs) will continue to increase as: more of the simpler calls are routed to automated services; alternative language services are expanded; and CSRs handle topics previously referred to compliance personnel.

During FY 2001, the IRS will introduce and test a new series of measures consistent with industry standards to improve monitoring of the delivery of the service experience and utilization of resources. The current measurement system will be maintained concurrent with this new effort through 2002 to allow IRS to solicit external expertise to validate and assess the new measures and develop an implementation plan. IRS will solicit external expertise to validate and assess the new measures and develop an implementation plan.

Earlier this year, the IRS also inaugurated its San Patricio, Puerto Rico call site. Now that the center is fully operational, it will be able to take the majority of the Spanish-speaking traffic. Our Spanish-speaking customer service representatives in the States will still play a critical role, but creating this center will allow us to make the best use of all of our bilingual assistors. By staffing this call site, we have made real progress in reducing the current deficit of Spanish speaking customer service representatives..

Forms By Fax and Phone

Taxpayers can receive more than 150 frequently used tax forms 7 days a week, 24-hours-a-day from IRS TaxFax. Taxpayers can request up to three items per-call. Taxpayers use their fax machine to dial the service at 703-368-9694. The only cost to the taxpayer is the cost of the call. Taxpayers can also request forms and publications by calling 1-800-TAX-FORM.

Recorded Tax Information

TeleTax has 148 topics available 24 hours a day using a Touch-tone phone. Taxpayers can call (toll-free) 1-800-829-4477 to hear recorded information on tax subjects such as earned income credit, child care/elderly credit, and dependents or other topics, such as electronic filing, which form to use, or what to do if you cannot pay your taxes. As of March 9, 2001, over 2.6 million have taken advantage of the service so far this filing season. Nearly 2.97 million taxpayers used TeleTax for the comparable period last year.

Automated Refund Information

In FY 2000, more than 13.79 million taxpayers used the Automated Refund Information system on TeleTax to check on the issuance of their refund checks. As of March 9, 2001, the number stands at over 23.8 million – up 73 percent from, last year. Taxpayers may call 1-800-829-4477 to check on their refund status Monday through Friday from 7 AM to 11:00 PM if using a touch-tone phone, or 7:30 AM to 5:30 PM for rotary or pulse service.

Taxpayer Assistance Centers

While many taxpayers prefer to use the telephone and the Internet to communicate with the IRS, our modernization studies and experience with the highly successful "Problem Solving Days" showed that some taxpayers need to meet in person with IRS representatives to get the assistance they need.

For those taxpayers who prefer to visit an IRS office, walk-in service is available at more than 400 locations nationwide. At many sites, walk-in service will be offered on 12 Saturdays between January 27 and April 14. So far this filing season, we have served over 3.37. million taxpayers at all Taxpayer Assistance Centers – a 4.54 percent decrease from last year.

The Saturday Service sites were selected based on their weekend accessibility, year-round operational status, and high traffic volume. They include non-traditional locations, such as shopping malls, community centers and post offices.

With the help of the additional personnel provided for by the STABLE initiative, we are broadening the services available in our local offices so that taxpayers who wish to come in person will be able to resolve most tax account issues. We have defined a new job category called Tax Resolution Representatives. These employees will have the training and authority to provide "one-stop service" for a broad range of issues ranging from answering tax questions to resolving payment problems.

We also believe that by energizing the VITA return preparation program and co-locating these activities at the Taxpayer Assistance Centers, the IRS will be able to focus on simple account and collection issues. In 2001, the Stakeholder Partnership, Education and Communications (SPEC) branch of our Wage and Investment Operating Division will work with more than 17,000 volunteer sites across the country to assist an estimated 4.6 million taxpayers. We will also work to better track the impact and benefits of the volunteer program.

SERIOUS CHALLENGES REMAIN

Mr. Chairman, in spite of the progress the IRS has made since the enactment of RRA 98, it is clear that we are still not providing the level and quality of service that taxpayers deserve, nor are we collecting the taxes due efficiently.

As previously discussed, the level of phone service – while improving – is still unacceptable and not on a level with what taxpayers receive in the private sector. We cannot provide taxpayers with up-to-date information on their accounts, resulting in enormous frustration for both taxpayers and the IRS employees who want to help them. In fact, nearly all of our business processes operate too slowly, inaccurately and inefficiently. Many of our notices are still confusing and poorly written. Achieving the 80 percent electronic filing goal by 2007 will be very difficult.

The IRS is also deeply concerned about the continued drop in audit and collection activity. In fact, the GAO testified before the Senate Finance Committee in February 2000 that the current level of IRS enforcement activity is too low. Clearly, the declines we have witnessed in the past few years must stop or the fairness and effectiveness of our tax system will be undermined. The risks of these declines are not simply the dollar value of the taxes left uncollected. The greatest risk is that the average taxpayer who honestly pays taxes loses confidence if the IRS fails to act effectively and efficiently to collect from those who do not pay what they owe.

To help address these problems, the President's budget includes follow-on funding for the STABLE initiative, begun earlier this year. These funds will complete the hiring of almost 4,000 staff and will enable the IRS to address the declines in audits and the drop in customer service that have occurred over the past several years.

Mr. Chairman, the drop in exam and collection activity in FY 2000 was caused by several factors, including the long-term decline in staffing, the need to assign compliance staff to customer service duties during the filing season, and added RRA 98 responsibilities.

Between FY 1992 and 2000, the Agency's workforce fell by 17 percent while the number of tax returns filed (including supplemental documents, such as Forms 1040X, 4868,2688, 1120X and 7004) increased 13 percent to 230 million. RRA 98 also created very significant additional resource demands on the IRS Exam and Collection staffs. Expanded programs, such as the innocent spouse provisions, offers in compromise and due process in collection required more that 4,200 IRS staff annually for administration. Other provisions, such as the requirements for notifications of third parties, tacked on more time to complete each exam and collection case. More than 30 additional steps have been added to the completion of an exam.

RRA 98 also had some very profound indirect impacts on IRS operations. Two provisions, in particular, have greatly affected the time required to conduct many activities. They are: Section 1203, commonly known as the "ten deadly sins" provision, and Section 1204, which broadly prohibited use of enforcement statistics in setting goals or making personnel evaluations at any level in the IRS.

Section 1203 caused a great deal of concern, caution, and hesitation among front-line employees and their managers with respect to taking enforcement action. And Section 1204, prohibiting use of enforcement statistics, caused a great deal of confusion and hesitation among managers to use any quantitative data to evaluate operations or to direct employees with respect to matters of time and efficiency. The effect of Section 1204 has been magnified by the extensive number of investigations and disciplinary actions of managers that was undertaken in 1998 and 1999 for misuse of statistics. In addition, uncertainty over the reorganization, which flattened the organization and eliminated management layers, caused some temporary loss of focus. The effect of all these factors was to increase the time it takes to complete cases, reducing the number of cases completed per FTE by 20 to 30 percent.

In its March 2001 financial audit of the IRS' Fiscal Year 2000 Financial Statements, the GAO pointed out the continued problem with the IRS' management of unpaid tax assessments. The GAO found that the IRS' "inability to actively pursue significant amounts in outstanding taxes owed to the federal government continue to hinder IRS's ability to effectively manage unpaid assessments."

The GAO report pointed to a much larger and fundamental weakness that threatens the IRS' mission: the pressing need to overhaul IRS' systems and processes. The IRS core data systems that record taxpayers' tax accounts are fundamentally deficient. The IRS will never be able to perform its mission without replacing these systems. The solution to these problems is not simply to do more of everything in the way it has always been done. Instead the solution is to modernize the IRS to do things more efficiently and effectively.

Replacing virtually the entire technology infrastructure in the next 10 years, while also delivering short-term service improvements demanded by taxpayers, employees, and the Congress, remains an enormous challenge fraught with risk. But we have no choice; we must move ahead for the good of America's taxpayers and the good of our Nation. The President's budget includes close to $400 million in investments to modernize the IRS' outdated computer systems. This multi-year project will provide the IRS with the modern tools needed both to deliver first class customer service to America's taxpayers and to ensure that compliance programs are administered efficiently.

Mr. Chairman, there have also been some questions as to whether the "audit rate" as publicly reported by the IRS understates the ability of the IRS to verify the accuracy of individual tax returns. Simply focusing on the audit rate does substantially understate the IRS' capacity to find errors in returns, especially in certain kinds of returns. In my many press interviews in the past few years in which this topic has come up, I have consistently made this point, often citing our computer matching program as an example of a technique that the IRS uses in addition to traditional audits.

With the use of document matching and other return verification techniques for more that will eventually be enabled by new technology, it is my view that there is no need to return to the levels of individual audit coverage that existed even five years ago, which was three times the FY 2000 level. The IRS strategic plan and budget proposals as presented to the IRS Oversight Board do not call for this approach. However, our strategic plan sets forth an approach in the short run to stabilize our level of traditional compliance activities, such as individual audits, at or slightly above current levels and to focus them on the areas where they are most required. In the long run, we will rely on our business systems modernization program to increase the effectiveness and efficiency of these activities.

The IRS has for many years relied on a range of techniques to verify certain items on tax returns. Each of these techniques is appropriate for particular classes or types of potential errors. With respect to Information Returns Processing, or document matching as it has often been called, this technique is very effective for verifying income items reported by third parties, including wages, interest, dividends and miscellaneous payments. It can also be used to verify gross sales of assets, ~~but canno~~t be used to verify the gain or loss on such sales since we have no third-party reporting on the cost basis of assets. It is also of limited value in verifying some deductions, such as mortgage interest.

Document matching is not useful for verifying business income, gain or loss on asset sales, or most itemized deductions. We estimate that the total personal income that cannot be verified by document matching represented about $1.2 trillion in FY 1998, or 19.7% of total reported personal income. An important role of audits is to verify these major categories of income and deductions.

The significance of verifying income and deduction items through audits is illustrated by the fact that the average in-person audit of an individual return results in an assessment of approximately $9,540, while the average assessment from a document matching case is $1,506. In FY 2000, the IRS closed 277,212 in-person audits of individual returns and assessed $2.4 billion from this program; in the document matching program in FY 2000, the IRS closed 1,353,545 cases and assessed $2.1 billion.

With respect the question of why document matching cases are not considered audits, the technical reason is that Section 7605(b) of the tax code generally limits the ability of the IRS to require a taxpayer to submit books and records for inspection by the IRS more than once. Since document matching cases do not require the taxpayer to submit books and records to the IRS, a document matching case does not preclude a subsequent audit. Revenue Procedure 94-68 specifically defines IRS taxpayer contacts, including document matching, which are not considered audits for the purpose of Section 7605(c). More generally, it is my understanding that some years ago the IRS proposed to change the definition of an audit to permit inclusion of the document matching cases in the overall reported number of audits and this proposal was criticized as possibly inflating IRS's statistics.

Notwithstanding these previous issues, all of IRS statistics, including the number of document matching cases, are publicly reported and it is our goal to make these reports as informative and meaningful as possible.

TURNING THE CORNER

Although overcoming these weaknesses is an enormous challenge, the IRS has achieved the first modernization milestones. If we continue to build on these initial successes, taxpayers and our tax administration system can begin to realize the benefits of modernization.

Organizational Modernization

Following RRA 98's directions, the IRS designed and has made substantial progress in implementing a new organizational structure. It closely resembles the private sector model of organizing around customers with similar needs. The IRS created four customer-focused operating divisions to best serve taxpayers: Wage and Investment, Small Business and Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. There are also a number of functional units, including Appeals, the Taxpayer Advocate Service, Criminal Investigation, and Communication and Liaison.

The modernized IRS organization was officially inaugurated, or "stood up", on October 1, 2000 and a top management team is in place for each of the operating divisions and business units. However, many challenges and much hard work remain as the different parts of the new organization are staffed and trained. The final stages of implementation, including the redistribution of workload, will require another two years through FY 2002.

In the short-term, the reorganization should be largely invisible to taxpayers and tax practitioners. In the long-term, they will see the positive changes that modernization is intended to produce. The new organization will place a greater emphasis on pre-filing services and early resolution of complex issues. More resources will be devoted to pre-filing activities, such as education and outreach to help taxpayers comply with the tax law and get their tax returns right the first time. Post-filing activities will be geared to problem prevention with targeted enforcement activities for non-compliance. Most importantly, the focus and clear assignment of responsibility will result in faster action to fix problems and improve the way that business is done.

Business Systems Modernization Program

The Problem

For an organization so critically dependent on technology, IRS' systems are woefully obsolete and inefficient. The facts cannot be disputed. The IRS is saddled with a collection of computer systems developed over a 35-year period. The most important systems that maintain all taxpayer records were developed in the 1960s and 1970s.

In an age of faster and more powerful computers, taxpayers are shocked to hear that their most important personal financial data is stored and updated once a week on magnetic tape. Our jury-rigged system of computers poses other problems. As *Money Magazine* observed in its April 2001 edition, "overlaying new software onto old has created a hodge-podge of data bases, many of which do not talk to one another. Until our consolidation as part of the Y2K program, there were 147 mainframes and 8,700 software products."

The effect of this obsolete technology on service to taxpayers and productivity also cannot be disputed. As compared to what the private sector can offer, the IRS' services are wholly unsatisfactory.

Many credit card companies and banks provide their customers with real-time account information; their phone representatives can often make adjustments on the spot. However, due to our archaic technology, IRS employees often do not have access to current taxpayer account information. Adjustments to a taxpayer's account may not take effect for up to 16 days because of delays in updating files and data among different systems cannot be synchronized. Payments and notices cross in the mail, often generating more notices and frustration.

Indeed, the IRS has only a 40 percent rate for correctly resolving an account problem over the phone the first time e.g., a payment is not posted to a taxpayer's account or taxpayer does not understand why he or she received a bill for an estimated penalty. Our overall account quality is improving but in this filing season is still only 70 percent

While the IRS Web site has proven to be an extraordinarily valuable source of information for taxpayers, we cannot yet use the Internet to provide taxpayers information about their returns or their tax accounts, or to exchange messages to resolve issues.

Inadequate technology and the concomitant lack of accurate data also seriously hamper our ability to identify and collect unreported or unpaid taxes. Individual audits are not started until 14-20 months after a return is filed. When they are started, the information available to our auditors is limited, extending the time to complete the audits and increasing the burden on the taxpayer. Collection of outstanding balances of individual and business taxes is extremely slow, usually taking years rather than months as in the commercial world.

The Opportunity

By taking full advantage of proven best business practices and new technology, we can greatly improve performance on all three of our strategic goals. The IRS can improve service to taxpayers and reduce their burden. The IRS can improve compliance and its collection activities, ensuring that the tax laws are fairly administered. And we can do this with limited increases in staff resources. Taxpayers will reap the benefits in a number of key areas, such as speed, access and accuracy. Let me briefly illustrate how this works in each of these three areas.

Nearly all taxpayers will be able to file and pay electronically, regardless of the type of form or tax. Taxpayers filing electronically and having correct returns would receive refunds in their bank accounts within 2 to 3 days.

We will emulate the best business practice of providing service to customers at times and through channels convenient to them, whether it is by phone, letter or on-line.

The level of phone service would increase to 90 percent. (Level of service measures the relative success rate of taxpayers who call the IRS through toll-free services and wish to speak to an operator. It excludes calls routed to automated systems.) We would expand web-based services to include exchange of information and resolution of accounts through the Internet. First time resolution of account inquires would double from 40 to 80 percent. Taxpayers would receive consistent and accurate answers to their questions regardless of the communications channel they chose. IRS employees would also have access to comprehensive taxpayer histories, thereby increasing the accuracy of the information and the transactions contained in them.

We also will provide more ways for taxpayers to resolve some issues by themselves, without requiring assistance from IRS staff. At the same time as we create the ability for taxpayers to check on such things as the status of their refunds and tax deposits through the automated systems on the telephone or the Internet, some in-person service requirements may be reduced. We are already beginning this process through such exciting initiatives as the EFTPS (Electronic Federal Tax Payment System) -OnLine program. It allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. And we have barely touched the full potential of electronic tax administration

The effect on our compliance activities would also be profound. Third party matching data would be made available earlier. Assembling all available data about a taxpayer case for our employees will avoid the need to get duplicate data from taxpayers. With the advent of many new best private sector practices, such as risk-based compliance techniques, the IRS also has the opportunity to allocate its compliance resources more efficiently, both in specific cases and around patterns of non-compliance. And when intervention is called for, we can use analytically-based techniques to assist in determining the appropriate action.

Most individual tax returns would be selected for audit within the same year and those audits will be completed more rapidly. "No change" determinations would be cut substantially.

The collection time for outstanding balances would be reduced to an average of six months. Improved systems will allow us to identify much more quickly which taxpayer accounts need attention from either telephone or in-person collectors. They will provide much more complete and accurate information to the collectors before they even deal with the taxpayer, and computer tools will assist them in closing cases.

These changes will also greatly increase our ability to "leverage" staff and use them more effectively and efficiently, while reducing the amount of time we take from taxpayers.

Our ability to ensure protection of taxpayer rights will be increased by building into the computer tools used by our employees the correct notifications and other protections prescribed by law.

The Solution

As I discussed in the introduction to my testimony, we are making substantial progress on the short-term improvement projects that support our major strategies. The other part of that dual approach is the Business Systems Modernization (BSM) program. It was established to take the IRS to the next level and make longer term, fundamental changes to our business processes and practices while managing the inherent risks of the process. Over the remainder of this decade, it will deliver the major benefits to taxpayers and our tax administration system that modernization and RRA 98 are all about. And that process has already begun.

Earlier this fiscal year, the IRS Executive Steering Committee approved the Enterprise Architecture. It is the roadmap for modernizing the Agency's business systems and supporting information technology networks. The Enterprise Architecture (Version 1.0) will guide the agency's business and technology improvements in the coming years. The approval of the architecture marks a major milestone in our progress towards the goals of Business Systems Modernization and will enable us to design and build new business and technology projects that will be the backbone of the modernized IRS.

The IRS previously published a blueprint in 1997. It was the first comprehensive view of modernized tax systems and guided the IRS in efforts to update technology. The new Enterprise Architecture reflects the lessons learned since 1997 and incorporates elements of the IRS reorganization into the four new customer-oriented operating divisions. It is an evolving document designed for constant use, with updates scheduled for spring and fall 2001 and regular updates thereafter. This new blueprint will ensure that IRS business systems' technology is compatible. And it will enable IRS employees to do their jobs better and provide taxpayers better service.

Because of the scale, complexity and risk of BSM, we can only carry out the plan by defining manageable projects, which are subject to a disciplined methodology. Each of these projects will be carried out through a step-by-step "enterprise life-cycle" in which successively greater amounts of detail are defined. The process requires that a vision and strategy phase be completed as a first step, prior to commencing tasks such as infrastructure development, information systems delivery, or process-reengineering. The final milestone in the cycle is an initial "deployment" of a project as an operational system. The IRS' Enterprise Program Management Office manages this process.

Also key to BSM's success, is the Tax Administration/Internal Management Vision and Strategy Project. Through the project, we have instituted a practice that ensures the Operating Division Commissioners and staff develop and take ownership of a process and systems modernization approach that is consistent and integrated with the overall vision of the future IRS. The project's ultimate goal is to create an enterprise-wide view of tax administration that is reflected in BSM.

The Business Systems Modernization Organization (BSMO) has now identified all the major initiatives for the next several years that link directly to our major strategies. Moreover, BSMO defined the major dependencies between and among projects and created a sequencing plan for their initiation, development, and deployment. It has also estimated the costs associated with each initiative and developed multi-year spending estimates consistent with this program. It now has a strategy for achieving the major goals of business systems modernization. The following are some of the key projects we will be working on during the next three years and beyond.

- **Deployment of the Customer Communications 2001 Project** – The Customer Communications Project is the first deployment of a business capability under the BSM effort. It is now in final testing before deployment in the third fiscal quarter. The IRS will greatly improve the efficiency and effectiveness of IRS' Automated Call Distributors (ACDs) and provide customer service levels on a par with the private sector. Hardware and software improvements will be made to the telephone system that is used to receive, route and answer more than 150 million taxpayer telephone calls each year. At a later date, Internet access capabilities will be added. This project will deliver direct benefits by increasing the number of calls that can be answered with available staff and will be a critical foundation element for subsequent projects, since virtually all major systems require communication with taxpayers.

- **Development of the Customer Relationship Management Exam (CRM Exam) Project** – Development has already begun. Through CRM, the IRS tackles some of the most complex tax calculations, including carryback/ carryforward, the Alternative Minimum Tax, and Foreign Tax Credit. This initiative will enhance the revenue agent's capabilities, reduce exam time, produce consistent results and reduce the burden on taxpayers who must deal with the IRS on these complex tax issues.

- **Development of the Security and Technology Infrastructure Releases (STIR)** – The design for STIR was approved and development was initiated. This project provides the essential underlying security infrastructure for the planned 2002 project deployments of the Customer Account Data Engine (CADE), Customer Communications (2002), and e-Services and Customer Account Management System. Development, testing and first release are expected by October 2001.

- **The Customer Account Data Engine.** (CADE) is the cornerstone of the data infrastructure. It is designed to provide a modern system for storing, managing, and accessing records of taxpayer accounts. CADE will create applications for daily posting, settlement, maintenance, refunds processing, and issue detection for taxpayer accounts and return data. The database and applications developed by CADE will also enable the development of subsequent modernized systems.

  CADE is scheduled to be released in stages, beginning first with simple tax returns being moved into the new CADE system, followed by increasingly complex taxpayer returns. As more taxpayer account information is moved into the new CADE system through these staggered releases, other modernized applications will be put in place to provide the interfaces necessary for IRS employees, and affected taxpayers, to access and carry out transactions. System development, testing and initial deployment are expected to be completed by January 2002.

- **Development of the Enterprise Data Warehouse/Custodial Accounting Project (EDW/CAP)** – Today, the IRS has a variety of dedicated research databases, and also uses its operational databases for operations research/analysis. The timeliness, consistency and standardization of the data in these separate systems do not support integrated analysis and corporate-wide decision making. The inconsistent and redundant data in stovepipe systems can result in inconsistent management and reporting data.

  Through EDW/CAP project, the IRS will develop an integrated enterprise data warehouse to support organizational data needs, such as those that are critical to managing our new compliance initiatives. For example, it will provide a single integrated data repository of taxpayer account and payment/deposit information, fully integrated with the general ledger. And it will identify payment and deposit information at the point of receipt. The operating divisions will be given access to pertinent revenue, assessment, disbursement, and seized asset information. In addition, it will provide the IRS with the capability to maintain financial controls over the $2 trillion of tax revenue received annually.

- The **e-Services** project will support our ability to meet the overall goal of conducting most transactions with taxpayers and their representatives in electronic format, as required by RRA 98. By 2002, the e-Services will: (1) provide the capability to register new electronic return originators over the Internet; (2) permit delivery of transcripts to authorized parties electronically; and (3) allow third parties who are required to provide certain forms 1099 and information returns to check the taxpayer identification numbers for accuracy before submission.

An important aspect of e-Services project is that it will be one of the first projects to provide a practical and limited application to define and test the design of our critical security infrastructure for sending and receiving taxpayer data internally and externally.

- **Customer Account Management (Individual Assistance and Self-Assistance Operating Models).** In today's environment, taxpayers are often unable to receive timely and accurate responses to requests and inquiries. These operating models will provide improved technology and business processes that will enable the IRS to: better manage customer service functions; maintain and utilize customer data to improve taxpayer interactions with the IRS; provide comprehensive account and tax law assistance to taxpayers and practitioners; and manage the case work flow of customer inquiries. There is a separate release strategy for each of the operating models based on the customer segment that benefits the most from the new capabilities.

- **Tax Education (Direct and Indirect) Operating Models.** These models address improving business processes and operational systems within the pre-filing business area (*i.e.* before a return is filed). In the past, there has been minimal investment in pre-filing activities, such as making educational materials, information and forms more readily available. With the organizational modernization, pre-filing activities will become more prominent. The Tax Education Operating Models will help taxpayers reduce or eliminate errors before they become compliance problems by developing proactive and targeted educational materials that are available 24/7 in various formats from web-based products to published documents. Utilizing third-party partnerships, the IRS will develop and make available in plain language reliable educational information, guidance and advice.

- **Individual Assistance Operating Model for Reporting Compliance.** The current compliance environment has produced a number of problems, such as extended cycle times, reduced coverage and decreased customer and employee satisfaction. This project will have a significant impact on the present Reporting Compliance operational environment by providing: (1) robust, issue driven compliance planning that utilizes outcome-based improvement to ensure fair and effective selection of cases; (2) highly automated decision engines for risk-based case selection, treatment assignment and resource allocation to decrease cycle time; (3) electronic case files with pre-identified issues to support productivity gains and increased coverage; (4) case working tools, workflow management and remote access to critical data; and (5) new technology and processes to establish collectability, secure payments and facilitate payment agreements at the closure of cases. The IRS will deliver these new capabilities through four releases by 2006.

- **Filing and Payment Compliance Operating Model**. This is an end-to-end strategy to resolve collection issues quickly and fairly. It augments, refines and replaces existing processes and technology to enable the IRS to interact with taxpayers in a seamless and efficient manner. Protection of taxpayer rights at all times is an important component of this strategy. Taxpayers who are able to resolve their cases with no direct IRS contact are provided various self-correct options. Field or Collection Call center staff will assist taxpayers who need help to resolve their delinquent tax cases. They will have access to real-time data to ensure that appropriate actions are taken and taxpayer rights are protected. The operating model will decrease cycle time to approximately six months. We will deliver this operating model through four releases by 2007.

Establishing a Balanced Measurement System

All federal agencies must have appropriate quantitative performance measures. They are required by the Government Performance and Results Act (GPRA) and are essential to any large organization's proper operation. An integral part of our overall modernization program is establishing balanced performance measures that support and reinforce the IRS' mission and strategic goals. However, because of past IRS experience with measurements and RRA 98 requirements (Section 1204), developing appropriate measures is an especially sensitive and difficult task.

Critical to our efforts was establishing measurements based on what we needed and wanted to measure, rather than using what is most easily measured. Our balanced measurement system was designed to measure the progress we are making to achieve our three strategic goals: (1) service to each taxpayer; (2) service to all taxpayers and (3) productivity through a quality work environment.

Also critical is ensuring that measures are aligned at all levels, from the top of the organization to the front-line employee. This does not mean that all of the organization's levels and components have precisely the same measurements. Obviously, this would be impossible. Rather, it means that the measures or evaluations are aimed at encouraging the type of behavior that will advance the organization's overall strategic goals, and do not encourage inappropriate behavior.

In developing measures for each organizational level, it is important that each component of the balanced measurement system reflect responsibility at that level. At the top of the organization, management has control over strategies and allocation of resources. However, at the mid-level, managers have less control over these variables, but do exercise control over the effectiveness of training, coaching and guidance of employees. And at the individual level, each employee has control over his or her work and self-development.

In the balanced measures system being implemented, there will be quantitative measurements keyed to each of the three strategic goals (service to each taxpayer; service to all taxpayers and productivity through a quality work environment) at both the strategic level and the operational level. In general, quantitative measures will not be used at the individual employee level.

In September 1999, we issued a Balanced Measures Regulation to formally establish our new performance management system. The publication of the regulation, which followed a public comment period, set forth our structure for measuring organizational and employee performance.

At the strategic level, our measures are designed to gauge overall performance on accomplishing the mission and strategic goals. This level is meaningful for the IRS as a whole, or for those parts of it that are responsible for providing a full range of services to large sets of taxpayers.

We began identifying specific strategic measures in FY 2000 and will refine and finalize these measures in FY 2001. Experience has shown that the development of good performance measures is an evolving process that improves with time. Accordingly, we anticipate there may be changes to the specific measures. We expect, however, that the strategic intent behind these measures will remain firm.

At the operational management level, our measures are focused on successfully executing our core business functions within the organizational units. At this level, we derive the balanced measures of organizational performance as follows: customer satisfaction, business results and employee satisfaction. This can be easily contrasted with measuring at the individual level.

All quantitative measurements assess organizational performance, not individual performances. It is impossible to capture in any quantitative measurement system all that is important in evaluating an individual. As of January 2000, we redefined the system for setting and measuring performance expectations for nearly all managers and executives to align with the balanced measurement system.

For front-line employees, we do not use quantitative measurements to evaluate performance, except in certain submissions processing functions. In most cases, it is not practical to quantify the performance of an individual employee in a meaningful and appropriate way. Instead, we incorporate the desired activities and behavior consistent with the strategic goals into the "critical elements" of each employee's position description.

We began to implement the balanced measures system at the operational level in 1999, starting with the three functions, Customer Service, Examination, and Collection, that most directly affected large numbers of taxpayers and employees. We implemented the operational measures for these functions within the existing organizational structure and have now transferred these measures to the new organization.

Since that time, we approved additional balanced measures for Large and Mid-Size Business, Tax Exempt and Government Entities, Taxpayer Advocate Service, Information Systems, Criminal Investigation, Appeals, and for additional Submission Processing and

Customer Service product lines within the Wage and Investment and Small Business/ Self Employed Operating Divisions. We have slated balanced measures for the remaining organizational units for approval in fiscal year 2001. In the interim, we are using 64 indicative measures and workload indicators in our annual performance plan as we complete our measures development.

However, we still have work to do. We must agree on a final set of Agency-wide strategic measures and then begin implementing a comprehensive suite of strategic measures covering all taxpayer segments. Most importantly, we must continue to learn how to use balanced measures as a tool to achieve a high level of performance for all three of our strategic goals.

Development of the balanced measurement system and, even more so, learning the new ways of working will take years. By focusing our attention on what is important for achieving our strategic goals, we will stay on the right path and continue our progress.

Clean Financial Opinion as Reported by Lawrence W. Rogers, former IRS Chief Financial Officer and currently, Acting Director for Administrative Accounting, Systems and Policies

Mr. Chairman, due to the combined efforts of the IRS and the General Accounting Office, I am pleased to report that the GAO rendered an "unqualified" or clean opinion on the IRS' FY 2000 Financial Statements. This includes both the Revenue and Administrative accounts.

The GAO's opinion means that the IRS properly accounted for $8.3 billion in appropriated funds; over $2 trillion in revenues collected; and over $190 billion in refunds. In his message opening the FY 2000 Treasury Accountability Report, Secretary O'Neill stated that "Good stewardship of taxpayer resources is a responsibility I take very seriously." At the IRS, we also want to ensure that every manager and employee takes that responsibility seriously.

In fact, the success on the financial opinions can be greatly attributed to the hard work and dedication of the IRS staff; the significant improvements made to IRS' internal controls; and management focus placed on the financial audits. I would also be remiss if I did not recognize the hard work of our GAO auditors who provided us with such excellent advice.

Congress, too, has played an important role in insuring that the financial audit is an important factor when evaluating agency performance. And we thank you for your strong, vigorous and continued leadership in this area. In last year's appropriations hearings, the Chairman of the House Appropriations Subcommittee on Treasury, Postal Service, and General Government also stressed the importance of a clean financial audit for IRS. Planning is already underway to insure that we maintain the same level of commitment for the FY 2001 and all future audits.

To achieve the clean financial opinion, the IRS made significant improvements in several areas. Specifically, we:

- Implemented reconciliation procedures for IRS fund balances and ensured prompt review/reconciliation was performed;
- Revised our reporting and disclosure for the statement of net cost to properly classify IRS programs;
- Improved management of property and equipment (P&E) inventories;
- Improved our review and management of suspense accounts;
- Reduced the number of computer security weaknesses;
- Addressed issues related to safeguarding taxpayer data; and
- Improved our ability to substantiate unpaid assessments.

However, long-standing inadequacies in our financial reporting systems must still be addressed through the broader efforts to modernize the IRS' systems and organization as mandated by RRA 98. The ultimate key to better financial management at the IRS is improved technology. A complete description of our efforts and response to the GAO report may be found in Appendix A.

BUDGET SUPPORT FOR MODERNIZATION

The IRS modernization program, and particularly, Business Systems Modernization, is at a critical juncture. The President's budget request funds two major initiatives that will greatly help the IRS. First, the budget includes close to $400 million in investments to modernize the IRS' outdated computer systems. This multi-year project will provide the IRS with the modern tools needed both to deliver first class customer service to America's taxpayers and to ensure that compliance programs are administered efficiently.

Second, the President's budget also includes follow-on funding for the STABLE initiative, begun in 2001. These funds will complete the hiring of almost 4,000 staff and will enable the IRS to address the declines in audits and the drop in customer service that have occurred over the past several years. Further details on the President's request on the IRS will be included in the formal budget transmission to occur next week.

Mr. Chairman, in conclusion, I believe that the IRS is on the right track. We have demonstrated both the ability to make some short-term improvements in service, and more importantly, the ability to produce a viable and cogent strategic plan that will guide our efforts to make changes in the entire way we do business and provide service to taxpayers. With your continued support and support of the American people, I am convinced more than ever that we can succeed.

Appendix A – 2001 Financial Audit

GAO Findings

The IRS believes that the GAO report is generally accurate and we have submitted a number of specific comments that we believe expand upon the information contained in the report, rather than challenge its findings.

Management of Unpaid Tax Assessments

First, to address the issues related to Trust Fund Recovery Penalty (TFRP) processing (*e.g.*, delays in posting, related tax liabilities, etc.) an IRS task group was established to review and recommend necessary changes. This group developed programming requirements to design an automated TFRP system that allows for systemic links. Phase I initial programming has been completed. Phase II will be implemented in FY 2002 to systematically accept downloads of data and cross-reference payments received for assessments made.

Controls over Refunds

The GAO observes that the IRS does not always review Earned Income Tax Credit (EITC) claims in time to identify invalid claims. The IRS believes that this observation should be placed in the proper context.

The IRS has succeeded in several of its initiatives to prevent erroneous EITC refunds from being issued. Specifically, the IRS: (1) used its dependent database to identify questionable issues relating to EITC; (2) implemented the new legislation requiring re-certification before the taxpayer can claim EITC on the current tax year due to improperly claiming EITC in the previous year; (3) banned taxpayers from claiming EITC for either two or ten years after the tax year where there was a determination that the taxpayer's claim was due to intentional disregard of the rules and regulations, or fraud; and (4) implemented an automatic freeze on refunds where there is an open examination.

The results of our efforts are clear. Since 1999, the IRS worked over 55,000 re-certification cases. Our case reviews also resulted in 7,680 two-year bans and 62 ten-year bans for processing year 2000, and 337 two-year bans and two 10-year bans for processing year 2001 (as of mid-February).

Property and Equipment (P&E)

The IRS agrees with most of the GAO's comments regarding Property and Equipment. However, we do not believe that the report puts into proper perspective the substantial progress IRS achieved during FY 2000. We believe it is important to highlight the fundamental changes in the P&E management of IRS.

Prior to October 1999, there were multiple information systems organizations in IRS besides the Chief Information Officer (CIO). This was a major contributing factor to the lack of accountability and commitment in maintaining an accurate and complete Information Technology (IT) inventory, thus, resulting in the long-standing property material weakness.

Today, the IRS has one information systems organization with total responsibility for the IT inventory. Since October 1999, the Information Systems organization has made significant progress in improving how the inventory is managed and maintained.

To implement the GAO recommendation that "systems and controls be in place for FY 2000," the IRS devoted P&E employee resources to undertake and accomplish the task. The IRS had already established the Financial and Management Controls Executive Steering Committee (FMC ESC). It is chaired by IRS Deputy Commissioner Bob Wenzel and is the major coordination point in the IRS for improving financial management systems. The FMC ESC established the Property Subcommittee, consisting of executives of the offices of the CIO, Chief Financial Officer (CFO), and Procurement. This Subcommittee met weekly and made decisions to ensure systems and controls for P&E were developed and functioning for FY 2000 and the future. This Subcommittee will continue to function until all property issues are resolved.

The IRS also established the Asset Management Modernization Project Office whose full time job is to implement industry "best practices" and deploy new automation tools. A complete discussion of these and other improvement projects can be found in our response letter.

In summary, we believe that through the major automation and process improvements I have outlined, the IRS significantly reduced the long-standing material weaknesses identified by GAO. With continued executive support and dedicated staff resources, the momentum attained to date can be sustained, and the underlying deficiencies in IRS' property management eliminated.

Manual Tax Receipts and Taxpayer Information

On October 30, 2000, the IRS established a Subcommittee on Security under the FMC ESC. The Subcommittee provides an agency-wide senior executive forum to address, and to make decisions on, security policies and priorities. It focuses on efficiently and effectively implementing and communicating these policies and priorities throughout the IRS. The Director of the Office of Security is the Chair of the Subcommittee.

Computer Security

Recognizing the critical need to enforce federal law and regulations concerning privacy and non-disclosure of confidential tax information, the IRS created the Office of Security to establish and enforce standards and policies for all major security programs including, but not limited to, physical security, data security, and systems security. The OS provides the IRS with a proactive, independent security group that is directly responsible for the adequacy and consistency of security over all IRS' operations.

Our security approach is consistent with GAO's September 1996 report, *Information Security: Opportunities for Improved OMB Oversight of Agency Practices*, which noted that, "Such a program can provide senior officials a means of managing information security risks and the related costs rather than just reacting to individual incidents."

Using a security framework, we are setting priorities for resources and we are measuring and demonstrating success in improving the overall security posture of the IRS. We are also taking a proactive approach by conducting security reviews at the computing centers and campuses. Our Office of Security works closely with local and Headquarters management to develop solutions, monitor implementation, and conduct on-going reviews to ensure weaknesses do not recur.

Revenue Reporting and Distribution

In its report, GAO notes that there are continued weaknesses in fundamental internal controls. To address this issue, the IRS implemented procedural changes to ensure expedited processing of million-dollar returns. We also provided procedures to monitor timely posting of returns and to identify taxpayers who had not yet filed their returns. This will ensure processing prior to the end of the certification period.

The GAO also noted there was a delay in posting to the Highway Trust Fund and the Airport and Airway Trust Fund in the amounts of $346 and $34 million, respectively. There are three reasons why amounts received in a quarter are certified in a subsequent quarter: (1) late filed returns; (2) processing delays (lack of documentation, etc); and (3) subsequent activities. In the above cases, we needed additional documentation and returns were filed late. It should be noted that there is no penalty for late filing provided the taxpayer has submitted his or her payment on time.

IRS' Structuring of Installment Agreements and Compliance with the Internal Revenue Code

The IRS has made considerable improvements on the structuring of installment agreements. In FY 1999, twenty percent of the unpaid cases examined were non-compliant with the Code. In FY 2000, the non-compliant percentage dropped to two percent. To ensure that agreements are compliant, the IRS issued guidance to its employees. We are also developing training on processing new installment agreements.

Furthermore, the IRS is revising its guidelines to reemphasize the necessity of ensuring that installment agreements cover all outstanding taxes. If this cannot be accomplished, the case will then be handled in accordance with Offer-in-Compromise procedures. The IRS will also continue to monitor and enforce the guidelines on installment agreements.

Federal Tax Liens

The GAO has noted significant improvement in the IRS' processing of federal tax liens. To better refine the processing of liens, the IRS: (1) issued guidance to its employees and provided additional training; (2) instituted monitoring and enforcement of the processing guidelines for liens; and (3) centralized the control of the federal tax lien process to one site. Previously, the process had been decentralized to each of the 33 IRS districts.

Long-Term Efforts

A major concern shared by the IRS and taxpayers is privacy and security, both internal and external. Let me restate the IRS' commitment to recognizing taxpayer privacy to the maximum extent possible in all Service initiatives. Given the vulnerability of modern electronic information systems to cyber attacks, hacking, and natural disaster, we are focusing resources on risk management processes, secure messaging and authentication, physical security, cyber attack response capability and disaster recovery measures.

The IRS will make substantial progress in improving its stewardship of assets over the next two years, although much more will be possible through our longer-term business system modernization efforts. The following are some of the ways we will implement this strategy.

Privacy

The IRS will incorporate privacy protection principles into all of its programs and policies. We will enhance the privacy impact assessment methodology, applying it to all stages of a system's development and requiring it as a part of a system's certification.

Security

The IRS will establish a Critical Infrastructure Plan to ensure that information systems critical to the financial security of the United States survive. The IRS will also continue to work with the computing centers to enhance their physical security to Level V, the Department of Justice's highest physical security designation. In addition, we will assist service and computing centers in conducting integrated disaster recovery exercises. Furthermore, the IRS will review the state of its security and focus on providing solutions to identified vulnerabilities and completing security certifications of sensitive systems. The IRS will bring the Computer Security Incidence Response Center to full operational capability and will provide oversight of selected IRS program areas to ensure practices are consistent with policy and guidance.

Property Management (IT)

The IRS will enhance and enforce policies and procedures to ensure accountability for use of information technology (IT) property. There will also be a transition from the current internally developed IT property tracking system (Integrated Network and Operations Management System – INOMS) to a Commercial Off-the-Shelf (COTS) solution. The IRS will connect the IT asset system with the non-IT property management so there is one comprehensive property system throughout the IRS

Financial Systems

The IRS will implement a Joint Financial Management Improvement Program (JFMIP) approved financial management system. We will select a COTS product that best satisfies our internal management needs through an enterprise resource-planning product. Our first phase of implementation will be replacement of the core financial system, with planned future implementation of other internal management modules.

Strategic Plan

The Strategic Plan stresses that the IRS must demonstrate effective stewardship of the assets and information entrusted to it by improving our internal processes for information management, financial management, and asset management.

Conclusion

To summarize, the Internal Revenue Service is committed to improving financial management. We view all of these actions as necessary to build upon current processes and systems to provide the best financial information possible that meets statutory and policy requirements. Additionally, it must be stressed that the long-term solution to many of the issues identified through the audit process can only be addressed by the design and implementation of new or enhanced automated systems that will be developed over the next several years.

Mr. HORN. Well, thank you very much. That was an excellent statement, and we'll have more in a dialog on the questions. But, I'd like to now recognize the Honorable Larry R. Levitan, chairman of the IRS Oversight Board. Mr. Levitan, if you would, you might tell us a little bit about the Board, are the positions filled, and then whatever you would like to talk about. Let's talk about it.

Mr. LEVITAN. Thank you, Chairman Horn, Mr. Putnam. It's my pleasure, and I'm proud to represent the IRS Oversight Board and discuss our role in improving the operations of the IRS. As you know, the IRS Oversight Board was established by the IRS Restructuring and Reform Act of 1998, and it had three primary objectives: First, to strengthen governance of the IRS through independent oversight; second, to provide continuity through 5-year staggered terms of its members; and, third, to bring business-oriented input to the agency's operations.

During the year 2000, the seven private citizen members of the Board were nominated by the President and confirmed by the Senate. We held our first meeting in September 2000 and now meet for 2 days every 2 months. Since September, the focus of our activities has first been on getting ourselves up to speed on IRS operations which is not an insignificant task, reviewing and approving the IRS Strategic Plan that you heard about from Commissioner Rossotti, developing a recommended IRS budget for fiscal year 2002, actively participating in the evaluation of candidates for the Taxpayer Advocate position, advising the Secretary of Treasury on this appointment, participating in the selection of a new Chief Information Officer, and starting to build a professional staff for the Board.

We've also established three committees that focus on the important areas of modernization, personnel and organization, and performance management. While we are still a new organization and still have a lot to learn, we believe that we've gained a good understanding of many of the issues and challenges that the IRS faces.

Mr. Chairman, the problems faced by the IRS are almost too numerous to list. With that said, we're quite sure that the Board has not yet identified all of these problems, although the Commissioner and other senior executives have been very forthcoming in discussing these issues. One logical way to summarize the problems of the IRS is to state that it is not meeting, I repeat, not meeting any of the three strategic goals and objectives defined in its Strategic Plan. The IRS does not provide top quality services to each taxpayer in every interaction. For example, phone calls frequently go unanswered and notices to taxpayers are often difficult to understand.

The IRS does not provide top quality services to all taxpayers through fair and uniform application of the law. For example, the level of audits and other enforcement activities have fallen to an unreasonable low level.

The IRS does not provide productivity through a quality work environment. Because of outdated technology, the work environment is completely inconsistent with efficient and modern practices.

These problems are not a surprise and are well understood by Congress, by the Treasury Department, and by the IRS itself. They've been the subject of congressional hearings and led directly to the IRS Restructuring Commission and the passage of the IRS Restructuring and Reform Act of 1998. In addition, many of the operational changes mandated by RRA 1998 have been implemented and are starting to have a positive effect at the IRS and, more importantly, on taxpayers. During 1999 and 2000, the IRS was reorganized from a geographic structure to one built upon specific taxpayer needs. In the future this should provide the basis for building more specialized skills and improving services. Steps have been taken to improve the rights of taxpayers, the Office of the National Taxpayer Advocate has been strengthened, new rules and regulations have been put into place, and IRS employees have received extensive training.

Next, the IRS has brought in new managers from the business world and other government agencies, and this has strengthened our organizational capabilities. During 2000, the IRS prepared its first Strategic Plan in many years. This plan, which was approved by the Oversight Board in its January meeting, establishes a blueprint to operate and improve the agency over the next 5 years. The 2002 budget request that the Oversight Board developed was developed specifically to support this plan. An aggressive program to dramatically increase the level of electronic filing has been put in place and is showing real results. A well-designed Web site to support both taxpayers and tax preparers is in place and is one of the most widely used sites on the Internet.

The technology modernization program was started in 1997 and the Board is encouraged by what we see as real progress. Key IRS leadership is fully engaged and has taken ownership of this program. The program has been designed to include not just new technology, but improve business processes and new skills for IRS employees. A management governance program has been put in place to help ensure that the right people make appropriate decisions at the right time, and that funding is appropriately managed.

A new business systems modernization blueprint, which defines what work will be done, was approved this year and provides a plan for the entire program. A systems development life cycle methodology has been put in place to support and link governance of the program and how the work is conducted. Technology management has been consolidated under the leadership of a strong CIO with extensive and relevant private sector experience; and a technology consolidation program was recently completed, reducing the number of data centers and the number of mainframe computers. In addition, steps are underway to standardize the technology infrastructure across the entire agency and to improve data security.

Despite these accomplishments, there is still much to do. Short-term improvements are necessary to quickly improve customer services and stop the continued degradation of IRS enforcement activities. This will require ending, and to some limited extent reversing, the decade long reduction of IRS headcount. In the past 10 years IRS headcount has gone down 17 percent while the workload has increased significantly. The Board strongly recommends the full implementation of the STABLE program that was begun this year and should be completed in fiscal year 2002. This program will add approximately 3,800 new employees to improve services and start to address the reduced levels of enforcement.

Additional headcount, however, is not the way to address IRS challenges in the longer term. Modernization of technology and business processes provides the opportunity to create a new, more efficient IRS that will provide the kind of services that Congress and the American taxpayers demand.

As previously described, this modernization program is underway but still in its early stages. The program is very large, highly complex, and extremely high risk. The program will require continued investment and support as well as meaningful oversight by the Board and by Congress.

The Board urges Congress to give careful consideration to the modernization and improvement investments included in our recommended budget for 2002. I have submitted to the subcommittee, as part of my testimony, a discussion paper on the IRS Strategic Plan in our 2002 recommendation. This paper provides additional background on this issue, and I ask that it be included in the official record as part of our testimony.

Mr. HORN. Without objection, it will be put in the record at this point.

[The prepared statement of Mr. Levitan follows:]

Testimony of Larry R. Levitan
Chairman, IRS Oversight Board
Before the House Committee on Government Reform
Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations
April 2, 2001

Chairman Horn, members of the Subcommittee, my name is Larry Levitan and I am proud to represent the IRS Oversight Board and discuss our role in improving the operations of the IRS.

As you know, the IRS Oversight Board was established by the IRS Restructuring and Reform Act of 1998 with three primary objectives:

- Strengthen governance through independent oversight.
- Provide continuity through five year staggered terms.
- Bring business-oriented input to the agency's operations.

During 2000 the seven private citizen members of the Board were nominated by the President and confirmed by the Senate. We held our first meeting in September of 2000 and meet for two days every two months. Since September the focus of our activities has been:

- Getting ourselves up to speed on IRS operations.
- Reviewing and approving the IRS Strategic Plan.
- Developing a recommended IRS budget for fiscal year 2002.
- Actively participating in the evaluation of candidates for the Taxpayer Advocate position and advising the Secretary of the Treasury on this appointment.
- Participating in the selection of a new Chief Information Officer.
- Starting to build a professional staff for the Board.

We have also established three committees that focus on the important areas of:

- Modernization
- Personnel and Organization
- Performance Management

While we are still a new organization and still have a lot to learn, we believe that we have gained a good understanding of many of the issues and challenges that the IRS faces.

Mr. Chairman, the problems faced by the IRS are almost too numerous to list. With that said, we are quite sure that the Board has not identified all of the problems, although the Commissioner and other senior executives have been very forthcoming in discussing these issues.

One logical way to summarize the problems of the IRS is to state that it is not meeting any of the three strategic goals and objectives defined in it's Strategic Plan:

THE IRS DOES NOT *"provide top-quality service to each taxpayer in every interaction"*- for example, phone calls frequently go unanswered and notices to taxpayers are often difficult to understand.

THE IRS DOES NOT *"provide top-quality service to all taxpayers through fair and uniform application of the law"* – for example, the level of audits and other enforcement activities have fallen to an unreasonably low level.

THE IRS DOES NOT *"Provide productivity through a quality work environment"* – because of outdated technology the work environment is completely inconsistent with efficient and modern practices.

These problems are well understood by Congress, by Treasury, and by the IRS. They have been the subject of Congressional hearings and directly led to the IRS Restructuring Commission and the passage of the IRS Restructuring and Reform Act of 1998. The passage of RRA '98 was in the opinion of the Board landmark legislation that pointed the IRS in a new, long-overdue direction. Since then, the IRS has been reorganized and many changes have been implemented in the administration of the tax code to protect taxpayer's rights. The most important changes include:

- Interaction between the IRS and the American taxpayers were put on a fairer footing.
- The five-year term established for the Commissioner of the IRS has produced an atmosphere of continuity and improved leadership.

- The IRS Oversight Board was appointed and has begun to fulfill its responsibilities under the statute

In addition, many of the operational changes mandated by RRA '98 are have been implemented and are starting to have a positive effect at the IRS and more importantly, on taxpayers:

- During 1999 and 2000, the IRS was reorganized from a geographic structure to one built upon specific taxpayer needs. This should provide the basis for building more specialized skills and improving service.

- Steps have been taken to improve the rights of taxpayers, including:
  - The Office of the National Taxpayer Advocate has been strengthened.
  - New rules and regulations have been put in place.
  - IRS employees have received extensive training.

- Bringing in new managers from the business world and other government agencies has strengthened the organization.

- During 2000, the IRS prepared its first Strategic Plan. This plan, which was approved by the Oversight Board at its January meeting, establishes a blueprint to operate and improve the agency over the next five years. The 2002 budget request was developed to support this plan.

- Steps have been taken to improve the communication and relationships between the IRS and Congress, the Treasury Department, GAO and other public stakeholders.

- For the first time the IRS received a clean opinion on their FY2000 financial statements from the GAO.

- An aggressive program to dramatically increase the level of electronic filing has been put in place and is showing real results. A well-designed web site to support both taxpayers and tax preparers is in place and is one of the most widely used sites on the Internet, and the busiest tax site on the World Wide Web.

The technology modernization program was started in 1997 and the Board is encouraged by what we see as real progress:

- Key IRS leadership is fully engaged and has taken ownership of this program.

- The program has been designed to include not just new technology but improved business processes and new skills for IRS employees.

- A management governance program has been put in place to help insure that the right people make appropriate decisions at the right time, and that funding is appropriately managed.

- A new business systems modernization "blueprint" that defines what work will be done was approved this year and provides a plan for the entire program.

- A systems development life cycle methodology has been put in place to support and link governance of the program and how the work is conducted.

- Technology management has been consolidated under the leadership of a strong CIO with extensive and relevant private sector experience.

- A technology consolidation program was recently completed, reducing the number of data centers and mainframe computers. In addition, steps are underway to standardize the technology infrastructure across the entire agency and to improve data security.

Despite these accomplishments there is still much to do. Short-term improvements are necessary to quickly improve customer service and stop the continued degradation of IRS enforcement activities. This will require ending and, to some limited extent, reversing the decade long reduction of IRS headcount. In the past ten years headcount has gone down 17% while the workload has increased significantly. The Board strongly recommends the full implementation of the STABLE program that was begun this year and should be completed in fiscal year 2002. This program will add approximately 3,800 new employees to improve service and start to address the reduced levels of enforcement.

Additional headcount, however, is not the way to address IRS challenges in the longer term. Modernization of technology and business processes provides the opportunity to create a new, more efficient IRS that will provide the kind of service that Congress and the American taxpayers demand. As previously described this modernization program is underway but still in it's early stages. The program is very large, highly complex and extremely high risk. The program will require continued investment and support, as well as meaningful oversight by the Board and Congress.

The Board urges Congress to give careful consideration to the modernization and improvement investments included in our recommended budget for 2002. I have submitted to the subcommittee as part of my testimony a discussion paper on the IRS Strategic Plan and our 2002 budget recommendation. This paper provides additional background on this issue and I ask that it be included in the official record as part of my testimony.

In closing, one obvious problem faced by the IRS and America's taxpayers is one I know the Congress continues to struggle with. While this problem is clearly outside the scope of the Board's responsibility, we believe the complexity of the tax code continues to create burdens to sound tax administration. As long as the tax code is as complex as it is today, the operations of the IRS and the service it provides to taxpayers will be negatively impacted.

Mr. Chairman, thank you for the opportunity to be here today. The restructuring and creation of a new and better IRS is very much a work in progress. The IRS Oversight Board is proud of its important role in this process, providing oversight and guidance as the IRS moves toward the goal of meeting its strategic objectives, creating an IRS which truly provides top-quality service to America's taxpayers. I appreciate this opportunity to report on our activities and our views on these critical matters and would be pleased to answer any questions that you may have.

x x x

IRS OVERSIGHT BOARD

Discussion Paper

IRS Strategic Plan and FY 2002 Budget Recommendation

During this past year, the IRS has spent a significant amount of time and effort developing a Strategic Plan for Fiscal Years 2000-2005. The plan, which was released in final form in February 2001, provides a logical and thorough road map for how the IRS will go about improving its operations and the services it provides to the taxpayers of this country. The IRS received input and assistance from its many stakeholders in completing the plan. The IRS Oversight Board, as required by the IRS Restructuring and Reform Act of 1998, thoroughly reviewed the plan. We discussed it at two of our Board meetings and approved it at our meeting on January 29-30, 2001.

The plan attempts to address the many concerns expressed by taxpayers, Congress and numerous organizations that work with the IRS. It defines an approach for creating a new IRS that supports and serves all taxpayers as well as ensuring that all appropriate taxes are collected. This is embodied in the new IRS mission statement:

> *Provide American taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.*

In support of this mission, three broad strategic goals were formulated:

- *Top-quality service to each taxpayer in every interaction*
- *Top-quality service to all taxpayers through fair and uniform application of the law*
- *Productivity through a quality work environment*

There is no argument that the IRS is not meeting these strategic goals at the present time. The plan therefore goes on to define guiding principles and major strategies for accomplishing these goals. The strategies define short-term steps that can be quickly implemented to address immediate needs. The plan also describes longer-term strategies, particularly systems and process modernization, that will take longer to implement but are necessary to create the kind of IRS that the public and Congress demand.

The IRS Oversight Board strongly supports the mission statement and strategic goals defined in the plan. Further, the Board believes that the strategies described in the plan provide a logical and appropriate approach to accomplishing these goals. Accomplishing this plan will be a long and difficult process. It will require significant work by the IRS and its advisors and contractors. As importantly, it will require the continuous oversight and support of the many stakeholders that are impacted by and work with the IRS, in particular the Administration and Congress.

At almost every well-managed business, the annual budget is fully linked and totally supportive of the long-term business strategy. This is not just "best practice," it is necessary and required practice. Unfortunately, this has not been the case at the IRS. Why? To begin with, prior to this year, the IRS has not had a strategic plan. In addition, the IRS budget has frequently been driven by short-term requirements, such as Y2K, and funding limitations that did not recognize the need to provide high-quality service to the American taxpayer. A key example is the 15 percent reduction in IRS headcount during the past decade while the workload required to serve taxpayers increased significantly.

The IRS Oversight Board's budget recommendation for FY 2002 is directly linked and completely supportive of the IRS Strategic Plan. The recommendation allocates resources into services to benefit more taxpayers more quickly. It calls for a modest increase in IRS operations, and a substantial longer-term investment in modernization and improvement.

The IRS Operations Budget

The IRS operations budget should be increased to account for inflation, mandatory cost increases, normal salary increases and promotions, boosting funding about six percent over FY 2001.

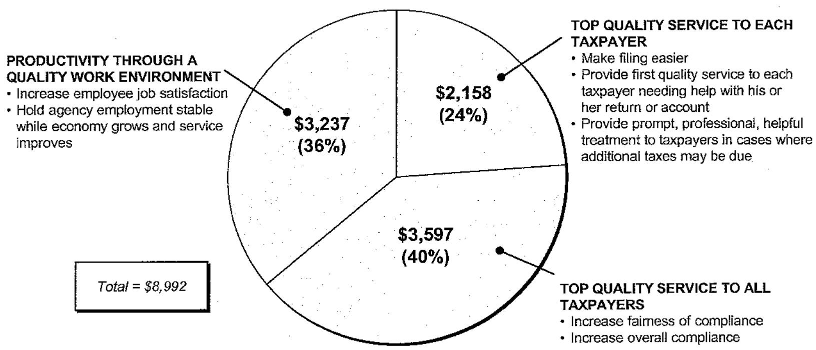
OPERATIONS BUDGET SUMMARY
(MILLIONS OF DOLLARS)

	FY2001	FY2002	% CHANGE
Operations Budget	$ 8, 497*	$ 8,992*	6%

** Includes EITC of $145 million for FY 2001 and $146 million for FY 2002; excludes user fees*

The operations budget is directly linked to the strategic goals of the IRS. About one quarter of the budget is dedicated to providing better service to each taxpayer, such as making filing easier, and providing prompt, professional taxpayer service. This represents a substantial increase in funding over previous years. Forty percent of the budget is focused on providing quality service to each taxpayer, particularly on ensuring fairness of compliance. And, about thirty-six percent of the budget is designed to achieve productivity through a quality work environment.

FY2002 OPERATIONS BUDGET TO IMPROVE CURRENT SERVICE LEVELS (MILLIONS OF DOLLARS)



The best way to understand how the IRS operations budget is linked to its strategic goals is to analyze changes between years. The FY 2002 budget significantly shifts resources and funding to activities that provide quality service to each taxpayer. Specifically, pre-filing services (such as taxpayer education and walk-in sites) and filing and account services (including phone customer service) are increasing by approximately 13 percent over fiscal year 2001 levels. The Board believes that resources should go where taxpayers need help.

The budget for compliance activities, shared services, and information systems programs are increasing at five to seven percent. These activities support the IRS' efforts to provide fairness in compliance, and in making improvements in productivity and quality in the workplace. Finally, several areas decreased or have below average increases. These include general management and administration, research, statistics of income and tax return processing. Increases in electronic filing is driving certain budget decreases, while simultaneously helping to improve the quality of service that the IRS provides taxpayers.

The Board believes that an important initiative included in the operations budget is full-funding for the Staffing Tax Administration for Balance and Equity (STABLE), begun in 2001. These funds will allow the completion of the hiring of approximately 4,000 staff and will enable the IRS to begin addressing the decline in taxpayer service, audits, and other compliance programs that have occurred during the past few years.

CHANGES IN OPERATIONS BUDGET FROM FY'01 TO FY'02

CHANGE IN BUDGET	DESCRIPTION	% CHANGE (FY'01 TO FY'02)
SIGNIFICANT INCREASE	• Prefiling Services ① • Filing & Account Services ①	13%
AVERAGE INCREASE	• Payment, Filing & Reporting Compliance ② • Shared Services Programs ③ • Information Systems Programs ③	5 to 7%
BELOW AVERAGE INCREASE OR DECREASE	• General Management & Administration ③ • Research & Statistics of Income ③ • Tax Return Processing & Information Reporting ①	(2%) to 4%
Overall Change in IRS Operations Budget		**6%**

STRATEGIC GOALS

① *Service to each taxpayer*

② *Service to all taxpayers*

③ *Productivity through a quality work environment*

The Information Technology Investment Account (ITIA)

The Information Technology Investment Account (ITIA) was established in 1998 as a mechanism to fund the massive Business Systems Modernization Program that was started in 1999. ITIA has several objectives. It provides for oversight and approvals that are necessary because of the size and complexity of this program and prior failures by the IRS in implementing major new systems. While funds are appropriated to ITIA during the annual budget process, they are only released to specific projects after review and approval by the GAO, TIGTA and Congress. A second and very important objective of ITIA is to provide a consistent level of funding that supports projects that go beyond one fiscal year. The history of the ITIA is as follows:

ITIA HISTORY
(MILLIONS OF DOLLARS)

FISCAL YEAR	APPROPRIATED	RELEASED	YEAR END BALANCE
1998	$ 294	$ -	$ 294
1999	211	35	470
2000	-	214	256
2001	72	328*	0*
2002	1,000**	450**	550**

** Projected based on current plans*
*** Recommended by IRS Oversight Board*

The IRS Oversight Board is concerned that for the first time, the ITIA will have a zero balance by the end of fiscal year 2001. This is a dangerous situation that could result in projects being inefficiently stopped and started or unnecessarily slowed down.

PROJECTS UNDERWAY AND FUNDED BY ITIA

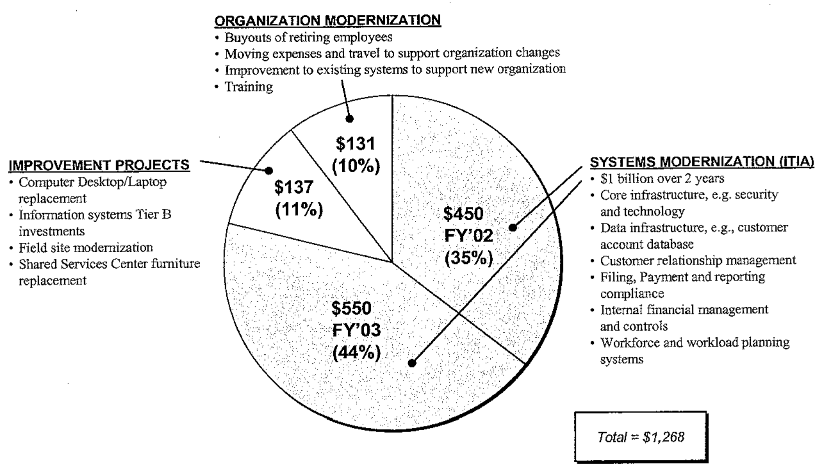
PROJECTS	TAXPAYER BENEFITS
Customer Communications	• Improved telephone system to handle 150 million taxpayer phone calls per year • Extended internet capabilities
Customer Relationship Management – Examination (CRM-EXAM)	Improved software that will provide more accurate processing and review of corporate income tax returns, saving time and money
e-Services	Allow for electronic transactions that yield better accuracy and efficiency
Customer Account Data Engine (CADE)	Modern system for storing, managing and accessing taxpayer records will provide better accessibility, accuracy and faster refund processing
Custodial Accounting	Financial management system will provide necessary control over taxpayer dollars
Infrastructure	Programs dealing with: • Security • Efficient voice and data transfer • Timely help desk assistance • Flexibility to address changes efficiently

IRS Modernization and Improvement Programs

The IRS Oversight Board also recommends funding in FY 2002 for Modernization and Improvement Programs of $1.268 billion.

In fiscal year 2002, the majority ($1 billion) of the funding relates to systems modernization through the Information Technology Investment Account (ITIA). The final implementation of organization modernization ($131 million) and other improvement projects ($137 million) account for the balance of the budget.

FY 2002 BUDGET FOR MODERNIZATION AND IMPROVEMENT PROGRAMS
(MILLIONS OF DOLLARS)



The $1 billion recommended appropriation for fiscal year 2002 represents a plan to release $450 million in 2002 and $550 million in 2003. The Board believes that funding the ITIA with two years of planned releases ensures that the program can move ahead as planned, without inefficient slowdowns or stops and starts.

Analyzing the changes in budget between fiscal years indicates that the organization modernization program budget is decreasing by $101 million. The remaining budget amount of $131 million reflects buyouts for retiring employees, moving expenses, and improvements to existing systems to support the new organization.

There is a recommended increase in budget of $97 million for other improvement programs. This includes computer desktop and laptop replacements, improvements in existing systems, field site renovations and shared services center furniture replacement.

A program of periodic upgrades to desktop and laptop computers to support the rollout of standardized software will provide improved functionality for IRS employees and enhanced security. Without this program, the enhanced software could not be delivered to many IRS employees.

Enhancements and additions to existing systems and certain new systems are necessary to support the new IRS organization structure that was put in place in 2000. The ability to manage this new organization and support the work of its employees will be significantly impacted without this program.

CHANGES IN MODERNIZATION AND IMPROVEMENT PROGRAMS
BUDGET FROM FY'01 TO FY'02
(MILLIONS OF DOLLARS)

	DESCRIPTION	FY2001	FY2002
Systems Modernization	• Security, technology and data Infrastructure • Customer relationship management • Filing, Payment and reporting compliance • Internal financial management • Workforce and workload planning	$ 72*	$ 1,000**
Organization Modernization	• Buyouts of retiring employees • Moving expenses and travel to support organization changes • Improvement to existing systems to support new organization • Training	232	131
Improvement Projects	• Desktop/Laptop replacement (2002) • Information systems Tier B investments (2001 and 2002) • Field site modernization (2002) • Shared Services Center furniture replacement (2002)	40	137
Total Modernization and Improvement Budget		**$ 344**	**$ 1,268**

** In addition to this amount, $256 million of carryover from FY2000 will be released in FY2001*
*** Includes $450 million for FY'02 and $550 million for FY'03*

The Board believes that the modernization program is absolutely necessary to support the longer-term strategies and objectives defined in the IRS Strategic Plan. The $450 million release plan for fiscal year 2002 and the $550 million plan for fiscal year 2003 are based on a detailed technology blueprint that also supports the plan. The technology blueprint's objective is to implement new systems as quickly as possible, consistent with the IRS' ability to manage both the change involved and the scale of the program. As described in the strategic plan, the implementation of the modernization program will clearly support meeting the goals and objectives of the IRS and the funds necessary to support this program are a necessary investment.

Conclusion

One of the most important responsibilities of the IRS Oversight Board is to review and approve the IRS Strategic Plan and budget. Since its inception in September 2000, the Board has spent a significant amount of its time and efforts on this objective. We are convinced that the strategic plan lays out as logical and realistic approach for addressing the many issues and challenges that the IRS faces. While many of the problems identified by Congress still exist, significant progress has been made and the strategic plan defines a way forward. The fiscal year 2002 budget recommended by the Board supports this plan. Taxpayers demand an IRS that supports their needs and administers the tax code fairly and fully. The programs and activities that are funded by the 2002 budget move the IRS toward that goal.

* * *

The IRS Board welcomes and encourages comments on its recommendations.

FY2002 OPERATIONS BUDGET DETAIL
(MILLIONS OF DOLLARS)

STRATEGIC GOALS AND OBJECTIVES	MAJOR STRATEGIES	FY2002 BUDGET REQUIREMENT		%
SERVICE TO EACH TAXPAYER • Make filing easier • Provide first quality service to each taxpayer needing help with his or her return or account • Provide prompt, professional, helpful treatment to taxpayers in cases where additional taxes may be due	• Meet the needs of the taxpayers • Reduce taxpayer burden • Broaden the use of electronic interactions • Meet the special needs of the tax-exempt community	Prefiling Services Filing & Account Services Tax Return Processing & Information Reporting **TOTAL**	$ 359 910 866 **$ 2,135**	24%
SERVICE TO ALL TAXPAYERS • Increase fairness of compliance • Increase overall compliance	• Address key areas of noncompliance • Stabilize traditional compliance activities • Deal effectively with the global economy	Payment, Filing & Reporting Compliance[1] **TOTAL**	$ 3,600 **$ 3,600**	40%
PRODUCTIVITY THROUGH A QUALITY WORK ENVIRONMENT • Increase employee job satisfaction • Hold agency employment stable while economy grows and service improves	• Recruit, develop and train a qualified workforce • Provide high-quality, efficient and responsive Information Systems Services and Shared Support Services • Promote effective asset and information stewardship	Tax Administration Training Shared Services Programs Information Systems Programs[2] General Management & Administration Research and Statistics of Income **TOTAL**	$ 64 1,121 1,593 371 101 **$ 3,250**	36%
TOTAL			**$ 8,985***	**100%**

1) Includes EITC of $146 million
2) Includes mandated IS special pay increases of $9 million; excludes Modernization and Improvement projects
** Note: There is a difference of $7million or 0.5% between the $8.985 total shown and the $8,992 budget amount. This is due to differences in data sources used to assemble this table.*

FY2002 MODERNIZATION AND IMPROVEMENT PROGRAMS BUDGET DETAIL
(MILLIONS OF DOLLARS)

PROGRAM	DESCRIPTION	FY2002 BUDGET
Systems Modernization	• Business Systems Modernization (BSM) – Core infrastructure, e.g. security and technology – Data infrastructure, e.g., customer account database • Tax Administration Vision & Strategy (TAVS) – Customer relationship management – Filing, Payment and reporting compliance • Internal Management Vision & Strategy (IMVS) – Internal financial management and controls – Workforce and workload planning systems	$ 1,000 for 2 year commitment FY'02 = $450 FY'03 = $550
Organization Modernization	• Buyouts of retiring employees ($30) • Moving expenses and travel to support organization changes ($13) • Improvement to existing systems to support new organization ($25) • Training ($15) • Projects to support implementation of new organization ($48)	$ 131
Improvement Projects	• Computer Desktop/Laptop replacements ($54) • Information Systems Tier B investments ($60) • Field site modernization ($15) • Shared Services Center furniture replacement ($8)	$ 137
TOTAL		$ 1,268

Mr. LEVITAN. In closing, one obvious problem faced by the IRS and America's taxpayers is one I know the Congress continues to struggle with. While this problem is clearly outside the scope of the Board's responsibility, we believe the complexity of the Tax Code continues to create burdens to sound tax administration. As long as the Tax Code is as complex as it is today, the operations of the IRS and the services it provides to taxpayers will be negatively impacted.

Mr. Chairman, thank you for the opportunity to be here today. The restructuring and creation of a new and better IRS is very much a work in progress. The IRS Oversight Board is proud of its important role in this process of providing oversight and guidance as the IRS moves toward the goal of meeting its strategic objectives and creating an IRS which truly provides top quality services to American taxpayers. I appreciate this opportunity to report on our activities and our views on these critical matters and would be pleased to answer any questions that you may have.

Thank you.

Mr. HORN. Well, thank you very much. And could you just answer, before I go to Mr. Dacey—are the members all in place for your oversight board?

Mr. LEVITAN. Yes. There are seven private citizens, the Secretary of the Treasury and the Commissioner of the IRS. We are all in place and have been in place since September of last year.

Mr. HORN. And they show up.

Mr. LEVITAN. They show up, they work hard and are all extremely active and dedicated.

Mr. HORN. Well, because it worried us all when the former President didn't make any appointments in a timely manner. So, you know, that bothered us.

Mr. LEVITAN. Right.

Mr. HORN. Now we have Mr. Robert Dacey, the Director, Information Security Issues, U.S. General Accounting Office, which is headed by the Comptroller General of the United States, Mr. Walker. I believe you're accompanied by Michael Brostek, Director, Tax Administration Issues; Randolph Hite, Director, Information Technology Systems Issues; and Steven J. Sebastian, Acting Director, IRS Financial Management Issues.

And I might add that with the Commissioner is Mr. Lawrence Rogers, Acting Chief Financial Officer. That's where all those hands were going up. Now we can hear from them. Do they talk as well as hold oaths? OK. Good.

Mr. DACEY. Mr. Chairman and Mr. Putnam, we are pleased to accept your invitation to be here this afternoon to discuss management challenges that continue to face the IRS in its efforts to improve its services to taxpayers and the efficiency of its operations through modernization.

As you requested, I will briefly summarize our written statement which covers four areas. In order of discussion, they are: computer security, financial management, organizational transformation and performance management, and business systems modernization management. The IRS has made important progress in each of these areas. Yet significant obstacles remain. The challenges that face IRS are longstanding and systemic challenges that require both short and long-term solutions.

In the area of computer security, IRS has corrected a significant number of previously identified weaknesses and is implementing a computer security management program which will, when implemented, help it to manage risks in this area. However, significant computer security weaknesses continue to exist that increase the risk of unauthorized disclosure, and the modification or destruction of taxpayer data. These weaknesses could impair IRS's ability to perform critical business operations.

For example, as illustrated by this chart, during last year's tax filing season IRS did not implement adequate computer controls to ensure the security, privacy, and reliability of its electronic filing, or e-file, systems. We demonstrated that individuals both internal and external to the Internal Revenue Service could have gained unauthorized access to IRS's e-file systems and could have viewed, modified, copied, or deleted the taxpayer data they contained. Further, they could have gained access to sensitive business, financial and taxpayer information and other critical IRS systems that were connected to the e-file systems through its service-wide network.

While IRS has stated that it does not have any evidence that intruders had accessed or modified taxpayer data, the agency did not have adequate procedures to detect such intrusions if they had occurred.

According to IRS officials, prior to the current tax filing season, the agency has corrected all of the critical vulnerabilities that we identified. We will assess the effectiveness of IRS's corrective actions as part of our normal followup review.

In financial management, IRS was able to prepare financial statements that received an unqualified or clean opinion. However, this achievement came through the use of substantial, costly, and time-consuming processes to work around serious systems and control deficiencies. Such deficiencies related to the management of unpaid tax assessments, the identification and collection of unpaid taxes, the disbursement of refunds, the handling of taxpayer receipts and data, administrative activities, and financial reporting.

Our written statement contains several examples that illustrate the impact of these weaknesses on IRS's ability to reduce taxpayer burden, collect all of the revenues due to the Federal Government, and to routinely produce reliable, useful, and timely information for day-to-day decisionmaking.

Looking at the IRS's structure, its progress in reorganizing around four taxpayer-focused operating divisions and developing a new performance management approach begins laying the foundation for making substantive changes to business practices. However, much work remains to complete the foundation and to design and implement business practice changes that noticeably improve services to the taxpayers and IRS's efficient administration of the tax system. Further, although IRS managers have a vital role in translating IRS's goals and objectives into actions that make a difference, they do not appear to have consistently revised their program management approach to be consistent with performance management principles.

Finally, in terms of business systems modernization, IRS's multi-year, multi-billion-dollar program is critical to achieving its new customer-focused vision and enabling it to meet performance and accountability goals.

Although IRS has made important progress in developing and implementing fundamental modernization management controls, we are concerned that projects are entering critical stages without a sufficiently defined enterprise architecture and a rigorous disciplined configuration management process, which considerably increases the risk that IRS's modernized systems will not deliver promised value on time and within budget. IRS officials have stated that they plan to have these controls in place by the end of this June. Given that IRS is seeking congressional approval of additional systems modernization funding, this is an opportune time to ensure that IRS addresses these risks.

In summary, IRS has clearly made important progress toward its decade-long effort to transform itself into a more reliable, accountable, and customer-focused organization. We have made many recommendations over the years to assist the agency in achieving this goal. Also, we have worked closely with IRS officials and will continue to do so.

Mr. Chairman, that concludes our statement. We would be pleased to answer any questions that you or Mr. Putnam would have at this time.

Mr. HORN. Thank you very much for, as usual, a very good presentation by the GAO.

[The prepared statement of Mr. Dacy follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform, House of Representatives

For Release on Delivery
Expected at
2 p.m. EDT
Monday,
April 2, 2001

INTERNAL REVENUE SERVICE

Progress Continues But Serious Management Challenges Remain

Statement of

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GAO-01-562T

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here this afternoon to discuss the management challenges that continue to face the Internal Revenue Service (IRS). At your request, our statement today will cover four areas: (1) computer security, (2) financial management, (3) organizational modernization and performance management, and (4) business systems modernization management.

Although we will address each of these areas individually, IRS' efforts in all four areas are interrelated and interdependent. IRS must make progress in all four areas to realize the modernization effort's full potential to improve IRS' efficiency and to significantly improve service to taxpayers. IRS has taken important steps in all of these areas. Yet along with improvements, significant obstacles remain. We have designated IRS financial management and information systems modernization as high risk, along with information security on a governmentwide level.[1]

The challenges that face IRS are longstanding and systemic management problems; they are challenges that require both short- and long-term solutions. While long-term solutions depend heavily on successful business systems modernization, short-term solutions can be implemented in many areas. We have made many recommendations to address these areas. Our statement today will make the following points:

[1] *High-Risk Series: An Update* (GAO-01-263, January 2001), *Major Management Challenges and Program Risks: Department of the Treasury* (GAO-01-254, January 2001), and *Major Management Challenges and Program Risks: A Governmentwide Perspective* (GAO-01-241, January 2001).

- In the area of computer security, IRS corrected a significant number of previously reported weaknesses, and is implementing a computer security management program that should, when fully implemented, help it manage its risks in this area. However, significant security weaknesses continue to exist in IRS' computing environment. These weaknesses could impair IRS' ability to perform vital functions and increase the risk of unauthorized disclosure, modification, or destruction of taxpayer data. To illustrate, we will today be discussing the agency's electronic filing *(e-file)* program, pointing out several areas where controls[2] necessary to ensure security and privacy of *e-file* systems and data were not in place during last year's tax filing season.

- In financial management, IRS this year was able to prepare financial statements that received an unqualified opinion, meaning that they were fairly presented. However, this achievement came through the use of substantial, costly, and time-consuming processes to work around serious systems and control deficiencies to produce financial statements that present information for just a single point in time. This approach does not provide for timely, useful, and reliable information to assist in managing the day-to-day operations of the agency, which was the intent of the Chief Financial Officers Act of 1990 and other important reform legislation enacted in the last decade.

[2] Internal control refers to IRS' plan of organization and all methods and measures it uses to monitor assets, prevent fraud, minimize errors, verify the correctness and reliability of accounting data, promote operational efficiency, and ensure that established managerial policies are followed. This encompasses all controls over access to computer systems and the data they process, and IRS ' management controls over its organizational changes and systems modernization.

While IRS has made some progress in addressing these issues, our audit of its fiscal year 2000 financial statements continued to identify several material internal control weaknesses and other reportable issues in addition to computer security.[3] These weaknesses and issues relate to (1) management of unpaid tax assessments; (2) identification and collection of unpaid taxes; (3) refunds; (4) taxpayer receipts and data; (5) administrative activities, including accountability for property and equipment and budgetary resources; and (6) financial reporting. These financial management issues affect IRS' ability to routinely report reliable information for decision-making and have led to both increased taxpayer burden and lost revenue to the federal government, thus affecting IRS' ability to effectively fulfill its responsibilities as the nation's tax collector. IRS continues to work to address these issues, and was able to fully resolve one longstanding material internal control weakness in fiscal year 2000. Nonetheless, continued efforts are needed to devise lasting solutions to IRS' financial management challenges. Some of these solutions can be achieved in the short term; others are longer term in nature, as they are dependent on the successful modernization of IRS' information systems.

- Looking at IRS' structure, the agency has reorganized into four taxpayer-focused divisions and developed a performance management approach consistent with management principles contained in the IRS Restructuring and Reform Act and the Government Performance and Results Act of 1993 (GPRA). IRS' progress in reorganizing around taxpayer-focused operating divisions and developing a new performance management approach begins laying the foundation for the next step in IRS' structural modernization—making substantive business practice changes that could significantly improve its efficiency and service to

[3] *Financial Audit: IRS' Fiscal Year 2000 Financial Statements* (GAO-01-394, March 1, 2001).

taxpayers. However, much work remains to be done in completing the foundation and in designing and implementing business practice changes that noticeably improve service to taxpayers and IRS' efficient administration of the tax system. Further, although the role of managers in translating IRS' goals and objectives into actions that make a difference is vital, managers do not appear to have consistently revised their programmatic decisionmaking in line with performance management principles.

- Finally, in terms of business systems modernization, we have long held that IRS needs to establish fundamental modernization management controls before it begins to build and implement modernized systems, and we have made recommendations to this end dating back to 1995. IRS has made important progress in developing and implementing these capabilities, but it is still not where it needs to be. We are therefore concerned that IRS is allowing its system acquisition projects to get ahead of its capabilities for managing them and ensuring that modernized systems deliver promised value, on time and within budget. While allowing acquisition and building management controls to proceed concurrently introduces an element of risk when systems acquisition projects are in their early, formative stages, the risk is considerably greater when these projects enter their later phases (detailed design and development). At these later junctures in the projects' life cycles, system rework, due to not employing disciplined modernization management controls, is much more expensive and time-consuming than it is earlier. Given that IRS needs additional money to invest further in the modernization, both near-term and longer term, and is seeking congressional approval of these funding needs, this is an opportune time to ensure that IRS addresses these risks.

We will now discuss each of these areas in greater detail.

COMPUTER SECURITY

As a major steward of personal taxpayer information, IRS has a demanding responsibility in collecting taxes, processing returns, and enforcing the nation's tax laws. In conducting its work, IRS must obviously depend to a great extent on interconnected computer systems. Due to the nature of its mission, IRS collects and maintains a significant amount of personal and financial data on each American taxpayer. These data typically include the taxpayer's name, address, social security number, dependents, income, deductions, and expenses. The confidentiality of this sensitive information is important because, should this information be disclosed to unauthorized individuals, American taxpayers could be exposed to a loss of privacy and to financial loss and damages resulting from identity theft and financial crimes.

Computer security is an important consideration for any organization that depends on information systems and computer networks to carry out its mission or business. However, without proper safeguards, systems and networks pose enormous risks that make it easier for individuals and groups with malicious intent to intrude into inadequately protected systems and use such access to obtain sensitive information, commit fraud, disrupt operations, or launch attacks against other computer networks and systems. And the number of individuals with the skills to accomplish this is increasing; intrusion—or hacking—techniques are readily available and relatively easy to use.

During fiscal year 2000 we continued to find serious weaknesses with general controls designed to protect IRS' computing resources from unauthorized use, modification, loss, and disclosure. IRS did not have adequate controls to

- prevent or detect unauthorized access to data processing facilities, computer networks, and systems;
- segregate systems administration and security administration responsibilities;
- optimally configure software to guarantee security and integrity of programs, files, and data;
- sufficiently plan and test actions necessary to restore critical business systems following unexpected occurrences; and
- monitor key networks and systems to identify unauthorized activities.

In addition, internal controls over key computer applications used by IRS personnel do not provide adequate assurance that access to taxpayer data is granted only to those authorized to have it. Such weaknesses increase the risk that data processed by IRS' computer systems are not reliable and remain vulnerable to unauthorized disclosure.

Although IRS corrected a significant number of computer security weaknesses cited in our previous reports, and is implementing a computer security management program that should, when fully implemented, help it better manage its risks in this area, we again reported computer security as a material weakness[4] in our review of IRS' fiscal year 2000 financial statements.[5]

[4] A material weakness is a condition that precludes an entity's internal control from providing reasonable assurance that material misstatements in its financial statements would be prevented or detected on a timely basis.
[5] GAO-01-394, March 4, 2001.

We recently examined the effectiveness of key computer controls designed to ensure the security, privacy, and reliability of IRS' electronic filing systems and electronically filed taxpayer data during last year's tax filing season. Our recent report discusses the computer control weaknesses that we found, along with actions that IRS states that it took to correct these weaknesses prior to this year's tax filing season.[6] What we have found to date concerning IRS' *e-file* program can illustrate the challenges that many organizations are facing.

IRS' *E-file* Program

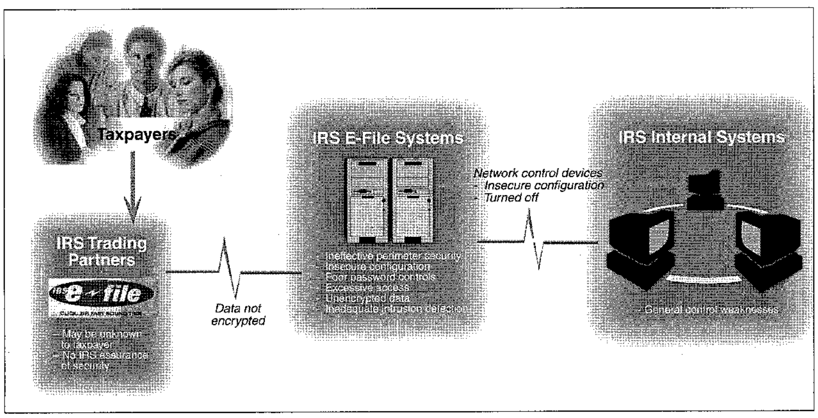
Electronic filing of income tax returns offers benefits to both taxpayers and IRS. IRS reports that taxpayers receive refunds faster and believes that electronic filing improves accuracy, decreases processing costs, and ensures the security and privacy of taxpayer data. We found, however, that during last year's tax filing season, IRS did not effectively implement computer controls to ensure the security and privacy of its electronic filing systems and electronically transmitted taxpayer data.

E-file is a major IRS initiative, and the number of individuals filing returns electronically is increasing. IRS reported that during 2000, over 35 million individual taxpayers filed their returns electronically—about 20 percent more than the previous year. In total, the number of *e-file* individual returns represented about 28 percent of all individual returns filed during 2000. The IRS Restructuring and Reform Act of 1998 established a goal that 80 percent of all tax and information returns—business as well as individual—be filed electronically by 2007.

[6] *Information Security: IRS Electronic Filing Systems* (GAO-01-306, February 16, 2001).

In an attempt to meet this goal, IRS has aggressively marketed the *e-file* program and has authorized private firms and individuals to be *e-file* trading partners. These partners include (1) electronic return originators, who prepare electronic tax returns for taxpayers; (2) intermediate service providers, who assist in processing tax returns; and (3) transmitters, who transmit the electronic portion of a return directly to IRS. Except for telefile taxpayers who file their returns using telephones, IRS does not allow individual taxpayers to transmit electronic tax returns directly to the agency; they must use the services of an IRS trading partner. Figure 1 demonstrates the path that an electronically filed tax return takes from the taxpayer to IRS.

Figure 1: *E-file:* 2000 Tax Filing Season.



During last year's tax filing season, IRS did not implement adequate computer controls to ensure the security, privacy, and reliability of its electronic filing systems and the electronically transmitted tax return data that those systems contained. We demonstrated that individuals, both internal and external to IRS, could gain unauthorized access to IRS' electronic filing systems and view, modify, copy, or delete taxpayer data. Our successful access did not require sophisticated techniques. Last May, for example, we were able to access a key electronic filing system using a common handheld computer. We could gain such access because IRS at that time had not

- effectively restricted external access to computers supporting the *e-file* program through effective perimeter defenses;
- securely configured its *e-file* operating systems, which used several risky and unnecessary services;
- implemented adequate password management and user account practices (for example, we successfully guessed many passwords and noted user IDs and passwords posted conspicuously on a monitor);
- sufficiently restricted access to computer files and directories containing tax return and other data (for example, all users had the ability to modify numerous sensitive data and system files, and certain users with no "need to know" had access, contrary to IRS policy); or
- used encryption to protect tax return data on *e-file* systems (as is required by IRS' *Internal Revenue Manual*).

Further, these weaknesses jeopardized the security of sensitive business, financial, and taxpayer data on other critical IRS systems that were connected to *e-file* computers through its servicewide network because IRS personnel turned off (bypassed) network control devices that were intended to provide security between *e-file* and other IRS systems. While IRS stated that it did not have evidence that such intrusions had actually occurred or that intruders had accessed or modified taxpayer data, the agency did not have adequate procedures to detect such intrusions if they had occurred. For example, it did not (1) record certain key events in system audit logs, (2) regularly review those logs for unusual or suspicious events or patterns, or (3) deploy software to facilitate the detection and analysis of logged events. Consequently, IRS did not recognize or record much of the activity associated with our tests.

These serious access control weaknesses existed because IRS had not taken adequate steps during the 2000 tax filing season to ensure the ongoing security of electronically transmitted tax return data on its *e-file* systems. For example, IRS had not followed or fully implemented several of its own information security policies and guidelines when it developed and implemented controls over its electronic filing systems. It decided to implement and operate its *e-file* computers before completing all of the security requirements for certification and accreditation.[7] Further, IRS had not fully implemented a continuing program for assessing risk and monitoring the effectiveness of security controls over its electronic filing systems.

According to IRS officials, the agency moved promptly to correct the access control weaknesses we identified prior to the current tax filing season. It developed plans to improve security over its electronic filing systems and internal networks, and said that it has substantially implemented those plans. In his response to our report, the Commissioner said that "electronic filing systems now satisfactorily meet critical federal information security requirements to provide strong

[7] Accreditation is the formal authorization for system operation and is usually supported by certification of the system's security safeguards, including its management, operational, and technical controls. Certification is a formal review and test of a system's security safeguards to determine whether or not they meet security needs and applicable requirements.

controls to protect taxpayer data." Sustaining effective computer controls in today's dynamic computing environment will require top management attention and support, disciplined processes, and continuing vigilance. We will assess the effectiveness of IRS' corrective actions as part of our normal follow-up review.

Application controls also need to be designed and implemented to ensure the reliability of data processed by the systems. IRS believes that electronically filed tax returns are more accurate than paper returns, and has implemented many application controls designed to enhance the reliability of data processed by its electronic filing systems. However, we identified additional opportunities to strengthen application controls for IRS' processing of electronic tax return data. Based on agency statistics, IRS processed electronic tax returns and paid refunds of about $2.1 billion without receiving required authenticating signatures or electronic personal identification numbers (PINs) from taxpayers. Data validation and editing controls did not detect certain erroneous or invalid data that could occur in tax returns. In addition, weaknesses in software development controls increased the risk that programmers could have made unauthorized changes to software programs during the 2000 tax filing season.

Further, taxpayers who filed electronically may not have been aware that transmitters, who actually send the data to IRS and may be unknown to the taxpayer, could have viewed and modified their data and that such data are transmitted to IRS in clear text—human readable form. This is because IRS decided (1) not to allow taxpayers to file most electronic returns directly to IRS, (2) to require taxpayers who elected to file electronically to use the services of third-party transmitters, and (3) not to accept electronic tax returns in encrypted form. In addition, taxpayers may not have been aware that IRS has no assurance of the security of its *e-file* trading partner systems. Other than providing guidance about protecting certain passwords, IRS did not prescribe minimum computer security requirements for transmitters and did not assess or require an independent assessment of the effectiveness of computer controls within the transmitters' operating environment.

We provided specific technical recommendations to improve access controls over IRS electronic filing systems and networks. We also recommended that IRS complete the certification and accreditation of its electronic filing systems, assess security risks and routinely monitor the effectiveness of security controls over electronic filing systems, improve certain data reliability and integrity controls, and notify taxpayers of the privacy risks of filing electronically. IRS agreed with our recommendations and stated that it implemented most of the improvements, including correcting critical vulnerabilities, before this year's tax filing season; it further stated that the actions it has taken demonstrate a systematic, risk-based approach to correcting identified weaknesses. Such an approach will continue to be important in ensuring that corrective actions are effective on a continuing basis and that new risks are promptly identified and addressed.

FINANCIAL MANAGEMENT

IRS' financial management has long been problematic. In fiscal year 2000, it continued to be plagued by many of the serious internal control and financial management issues we have been reporting each year since 1992.[8] Despite these issues, as we recently reported,[9] IRS was able to produce, in fiscal year 2000, combined financial statements encompassing both its tax custodial and administrative activities that were, for the first time, fairly stated in all material respects.[10] This achievement was the culmination of 2 years of extraordinary work on the part of IRS to develop compensating processes to work around its serious systems and control weaknesses to derive reliable year-end financial statement balances.

IRS' approach entailed costly, time-consuming processes, statistical projections, external contractors, substantial adjustments, and monumental human efforts that were not completed until over 4 months after the end of the fiscal year. Although this approach resulted in IRS' being able to report reliable fiscal year 2000 balances in its financial statements, it cannot achieve the central objective of the Chief Financial Officers' Act of 1990, which is to provide managers with the current, reliable information they need for day-to-day decisionmaking. In addition, this approach does not address the underlying financial management and operational

[8] *Internal Revenue Service: Recommendations to Improve Financial and Operational Management* (GAO-01-42, November 17, 2000).
[9] GAO-01-394, March 1, 2001.
[10] In fiscal year 1997, IRS received—for the first time—unqualified audit opinions on separate financial statements, covering its tax custodial activities (by us) and its administrative activities (by the Department of the Treasury's Office of Inspector General). In fiscal year 1998, IRS combined its tax custodial and administrative activities in one set of financial statements. We were able to determine in fiscal years 1998 and 1999 that the taxes receivable balance reported on the balance sheet and the tax revenue and refunds reported in the Statement of Custodial Activity were fairly stated.

issues that adversely affect IRS' ability to effectively fulfill its responsibilities as the nation's tax collector.

The tremendous commitment on the part of both IRS senior management and staff was key to IRS' ability to achieve its goal of receiving an unqualified audit opinion on its financial statements for fiscal year 2000. However, these costly and time-consuming efforts would not be necessary if IRS' systems and controls operated effectively. IRS' current financial management systems do not comply with federal financial management systems requirements, federal accounting standards, or the *U.S. Government Standard General Ledger* at the transaction level. Consequently, they do not substantially comply with the Federal Financial Management Improvement Act of 1996. Until IRS implements financial management systems that meet this standard and otherwise strengthens its internal controls, it will continue to be dependent on its workaround processes and heroic efforts to enable it to sustain an unqualified opinion on its financial statements.

IRS has laid the groundwork for sustainable improvement in several critical areas, and is taking action to address several of the management issues we have raised. However, it continues to have major financial management and operational problems, many of which will require a sustained, long-term commitment of resources, proactive involvement by senior management, and—ultimately—the successful modernizing of its financial and operational systems.

We would now like to summarize the major financial management challenges confronting IRS.

Management of Unpaid Tax Assessments

IRS continues to have serious internal control deficiencies that affect its management of unpaid tax assessments.[11] IRS still lacks a subsidiary ledger that tracks and accumulates unpaid tax assessments on an ongoing basis. As a consequence, it must rely on specialized computer programs to extract unpaid tax assessment information from its master files—its only detailed databases of taxpayer account information—and then subject this information to statistical sampling procedures in order to prepare its financial statements. However, this process takes months to complete and requires tens of billions of dollars in adjustments to correct misclassifications and eliminate duplications in order to produce a reliable balance at a single point in time. Additionally, IRS' automated records used in this process continued to contain errors. Finally, significant delays were encountered in recording activity in taxpayer accounts. These conditions continued to result in unnecessary taxpayer burden and lost opportunities to collect outstanding taxes owed during fiscal year 2000. For example:

- IRS continued to lack the ability to effectively link related taxpayer accounts so that payments made by one taxpayer are properly applied to reduce the tax liability of a related taxpayer. In 29 of the 68 unpaid payroll tax cases we reviewed (43 percent), payments were not accurately recorded to reduce the tax liabilities of all related taxpayers. In some

[11] Unpaid tax assessments consist of (1) taxes due from taxpayers for which IRS can support the existence of a receivable through taxpayer agreement or a favorable court ruling (federal taxes receivable); (2) compliance assessments where neither the taxpayer nor the court has affirmed that the amounts are owed; and (3) write-offs, which represent unpaid assessments for which IRS does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency. Of these three classifications, only the first is reported on the principal financial statements. As of September 30, 2000, IRS reported $22 billion (net of an allowance for doubtful accounts of $59 billion), $30 billion, and $129 billion in these three categories, respectively.

instances, we identified delays of up to 12 years in recording payments to all related taxpayer accounts, and in other instances payments were still not properly reflected, despite the fact that the payments were made in the late 1980s.

- IRS continued to experience significant delays and errors in recording other information in taxpayer accounts. In one case, it erroneously recorded a $68 million payment to the wrong taxpayer's account, resulting in the taxpayer who made the payment waiting nearly 2 years to receive a $7 million refund to which the taxpayer was entitled. In two other cases, IRS' failure to update information in taxpayer accounts resulted in refunds being paid to individuals who should not have been paid because they had other outstanding tax liabilities.
- IRS continued to experience problems in promptly releasing liens filed against the property of taxpayers who at one time owed the federal government for taxes but who had subsequently paid these taxes. In one case, a taxpayer paid off his outstanding tax liability in August 1998, yet it took IRS until March 2000—19 months later—to release the tax lien. By law, tax liens are required to be released within 30 days of the date the taxpayer satisfies the outstanding tax liability.

The serious internal control issues IRS continues to experience with its unpaid assessments can lead, and have led, both to undue taxpayer burden and lost revenue to the government. These conditions can also further erode the confidence of the nation's taxpayers in the integrity and fairness of the tax collection process.

Identification and Collection of Unpaid Taxes

Unpaid taxes includes taxes due the federal government that (1) taxpayers have reported to IRS or that taxpayers have not reported and IRS has identified through other means[12] and has recorded in its accounting records, (2) taxpayers have not reported but that IRS has identified through other means and has estimated the amount due, and (3) taxpayers have not reported and which IRS has not identified through other means. Inherent in the voluntary nature of the nation's tax collection system is the concept that IRS must, to a large degree, rely on taxpayers to report their tax liabilities. When taxpayers either intentionally or unintentionally fail to report to IRS the full amount of taxes they owe the federal government, IRS' ability to independently identify the taxpayers and determine the amount they owe is inherently limited. However, IRS does not always follow up on potential unpaid taxes it is aware of, and does not always pursue collection of those taxes it determines are owed. For example:

- Between fiscal years 1996 and 1998, IRS identified over 39 million potential cases in which taxpayers may have understated the amount of taxes they owed the government. Potential underreported taxes related to these cases were estimated by IRS at over $49 billion. However, IRS investigated fewer than 9 million of these cases, with total estimated underreported taxes totaling about $19 billion, leaving $29 billion in potential taxes uninvestigated and thus not pursued.

[12] IRS' other means of identifying unpaid taxes include its automated matching programs, nonfiler program, and examinations.

- As of September 30, 2000, IRS had recorded $240 billion[13] in unpaid taxes, penalties, and interest in its accounting records. During our audit of IRS' fiscal year 2000 financial statements, we continued to identify unpaid tax cases with some potential for collection that were not being actively worked on by IRS. In one case, a taxpayer with an annual income of over $110,000 owed $23,000 in unpaid taxes, but IRS was not pursuing collection.

As with any large agency, IRS is confronted with the ongoing management challenge of allocating its limited resources among competing management priorities. Its challenge is to determine the appropriate level of resources needed to fulfill its mission and the most appropriate utilization of its existing resources. However, IRS does not have the management data necessary to prepare reliable cost-benefit analyses to assess whether its resource allocation decisions are appropriate. Consequently, IRS is hindered in its ability to determine if it is devoting the appropriate level of resources to identifying and pursuing collection of unpaid taxes relative to the costs and potential benefits involved. This lack of such data also renders IRS unable to determine if it needs additional resources or to justify requests for resource increases to the Congress. This increases the risk of billions of dollars in amounts owed to the federal government going uncollected, and the further erosion of public confidence in the tax collection system.

[13] Of this amount, $129 billion represents write-offs, which are unpaid tax assessments for which IRS does not expect further collections due to factors such as the taxpayer's bankruptcy, insolvency, or death.

Controls Over Refunds

Weaknesses in IRS' controls over income tax refunds have potentially allowed billions of dollars in improper refunds to be disbursed. Time constraints,[14] high volume, and reliance on information supplied by taxpayers affect the options available to IRS to prevent improper refunds from being disbursed, and the preventive controls it employs are not always effective. Consequently, IRS relies extensively on detective controls, such as examinations of tax returns that its screening programs have identified as most likely to be invalid. However, these controls are often performed months after refunds are disbursed, requiring the government to incur the costs associated with attempting to recover these improper payments, often unsuccessfully. For example:

- Between fiscal years 1998 and 2000, IRS examiners identified invalid earned income tax credit (EITC) claims totaling $1.9 billion that may have resulted in the disbursement of $1.6 billion in improper refunds.
- In September 2000, IRS estimated that about $9.3 billion in invalid EITC claims were filed in tax year 1997. Based on an average refund rate of 78 percent that year, this may have resulted in the disbursement of about $7.3 billion in improper refunds related to EITC claims, about $6.1 billion of which (84 percent) may never be recovered.

These weaknesses result in losses to the government potentially totaling billions of dollars annually. They could also contribute to further erosion of confidence by the nation's taxpayers in the integrity of the tax collection system.

[14] By statute, IRS must pay interest on refunds not paid within 45 days of receipt or due date, whichever is later.

Controls Over Hard Copy Taxpayer Receipts and Data

Despite improvements during fiscal year 2000, IRS' internal controls over cash, checks, and related taxpayer data do not adequately protect the federal government and taxpayers from vulnerability to loss from theft and inappropriate disclosure of proprietary taxpayer information. IRS has significantly reduced the average amount of time it takes to obtain the results of employee applicant fingerprint checks; further, it now requires the use of two bonded or insured couriers to transport tax receipts to depository institutions, and has limited courier access within service center premises. However, significant but readily correctable weaknesses continued to exist. For example, at IRS locations we visited as part of our fiscal year 2000 financial audit, checks were left in open, unlocked containers, and personal belongings of IRS' employees were allowed into restricted areas where taxpayer receipts were being processed. These weaknesses increase the risk that taxpayer data could be inappropriately disclosed or receipts stolen.

New employees also continued to be allowed to handle tax receipts and sensitive taxpayer data before IRS received and evaluated the results of their fingerprint checks—despite a new IRS policy issued in April 2000 directly prohibiting it. Specifically, of about 19,500 employees hired during fiscal year 2000, about a quarter—some 4,900—began working before their fingerprint results were in. Of these 4,900 employees, 145 were hired after the April 2000 policy memo was issued, and 776 (16 percent) were subsequently found to have prior criminal arrests or convictions or other potentially unsuitable backgrounds that required further review.

A related vulnerability is that this IRS policy does not apply to individuals employed at ten commercial banks that process tax receipts for the agency. The Department of the Treasury's

Financial Management Service contracts with these banks to process manual tax receipts, but the banks are not required to fingerprint their employees. At the two banks we visited during our fiscal year 2000 audit, both obtained fingerprint checks for their permanent employees, but not until after they began to work processing tax receipts, and neither bank required fingerprint checks for temporary employees.

As a result of these weaknesses, IRS unknowingly hired new employees with unsuitable backgrounds and allowed them to begin working before it could ascertain whether they were suitable for their positions. These weaknesses subject IRS to unnecessary risk of theft or loss of tax receipts, and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS.

Accountability Over Administrative Accounts and Budgetary Resources

During fiscal year 2000, IRS made significant strides in correcting the weaknesses in accountability over its administrative accounts and budgetary resources that we reported for fiscal year 1999.[15] For example, IRS made major improvements in its policies and procedures over its fund balance with Treasury and amounts held in suspense. It is also working aggressively to address issues we have raised regarding its controls over its property and equipment and budgetary activity, but it continues to experience significant internal control deficiencies in these areas.

[15] GAO/AIMD-00-76, February 28, 2000.

Severe deficiencies in accountability for property and equipment have been reported by IRS every year since 1983. IRS lacks an integrated property management system to appropriately record, track, and account for property and equipment additions, disposals, and existing inventory on an ongoing basis. While IRS has made progress in improving the timeliness and accuracy of recording such activity in its inventory records, we continued to find significant errors in these records. For example, IRS was unable to locate 35 of 220 items we selected from its inventory records; these items included computers, monitors, printers, and computer software. In addition, because of the lack of an integrated property management system that includes reliable cost information on each item, IRS continued to need the assistance of a contractor to develop and implement a process to enable it to report reliable property and equipment-related balances in its financial statements. These weaknesses seriously impair IRS' ability to ensure that property and equipment are properly safeguarded and utilized only in accordance with laws, regulations, and management policy, and preclude IRS from having information on its balance of these assets throughout the fiscal year.

With respect to controls over IRS' budgetary activity, while we noted substantial progress, we continued to identify deficiencies. For example, amounts obligated when goods and services were ordered were often not updated in a timely way to reflect their receipt. This significantly reduces the reliability of key budgetary information IRS needs on an ongoing basis to effectively manage its operations and ensure that its resources do not exceed budgetary authority.

Financial Reporting

As noted, IRS cannot produce timely, reliable financial information for its managers to use in making decisions. Information produced by IRS' financial management systems is not current or accurate, and must be supplemented by extensive, costly manual procedures that take months to complete and require billions of dollars in corrections to derive financial statement balances that are not available until months later and are reliable only at a single point in time. As of September 30, 2000, fiscal year 2000 transactions totaling over $3.7 billion were either not yet recorded in IRS' general ledger or were recorded in the wrong account. All of these transactions had to be either recorded or re-recorded by IRS in subsequent months in order for it to prepare reliable financial statements. However, other information produced by IRS based on the data provided by its financial management system but not supplemented by these workaround procedures and material corrections may be unreliable, and could lead to inappropriate management or budgetary decisions stemming from incomplete, outdated, or otherwise erroneous information.

Another problem is that IRS does not track the cost accounting information needed to prepare cost-based performance information consistent with the Government Performance and Results Act of 1993. IRS relies on an internal coding structure to capture costs at a project and subproject level. Yet during fiscal year 2000, IRS staff were not required to use these codes for time charged to either of IRS' two largest appropriations,[16] which collectively accounted for 74 percent of all IRS budgetary resources. Consequently, managers did not have the basic

[16] IRS' two largest appropriations are Processing Assistance and Management and Tax Law Enforcement.

information they needed to prepare reliable cost-benefit data for internal decisionmaking and for budget justifications.

Remaining Financial Management Issues

While IRS' achievement of an unqualified opinion on its fiscal year 2000 financial statements is an important milestone, IRS continues to be challenged by serious internal control and systems deficiencies that hinder its ability to make this happen without heroic effort, and thereby achieve lasting financial management improvement. IRS decisionmakers need reliable, useful, and timely financial and performance information on an ongoing basis; this is the goal of the Chief Financial Officers Act. IRS' achievement this year likewise does not address the underlying financial management and operational issues that impair its ability to effectively fulfill its responsibilities as the nation's tax collector, nor does it provide the public with confidence that it is performing its job fairly and consistently.

The challenge for IRS will be to build on the goals reached in fiscal year 2000: to not only improve its compensating processes but, more importantly, to develop and implement the fundamental long-term solutions that are needed to address the management challenges we have identified. Some of these solutions can be addressed in the near term through the continued efforts and commitment of senior IRS managers and staff. Others, such as those involving modernizing IRS' financial and operational systems, will take years to fully achieve. Until IRS' systems and processes are overhauled and internal controls strengthened, heroic efforts will have to be sustained for IRS to continue to produce reliable financial statements.

IRS acknowledges the issues raised in our financial audits, and the Commissioner and Deputy Commissioner of Operations continue to pledge their commitment to addressing these long-standing issues. We have assisted IRS in formulating corrective actions to address its serious internal control and financial management issues by providing recommendations over the years, and we will continue to work with the agency on these matters.

We recognize that IRS' financial management systems were not designed to meet current systems and financial reporting standards; we also recognize that IRS' problems did not develop overnight. Successful implementation of IRS' longer term efforts and resolution of the serious problems that continue to be identified will also require substantial management commitment, resources, and expertise. This high level of involvement by IRS senior management has contributed greatly to IRS' successes to date. Such commitment and involvement must continue for IRS to address the fundamental problems it faces.

MODERNIZATION OF IRS' ORGANIZATIONAL STRUCTURE AND PERFORMANCE MANAGEMENT SYSTEM

Just as with its computer security and financial management, IRS has made progress in modernizing its organizational structure and its performance management system—a system designed to assess and improve organizational and employee performance in keeping with organizational goals. However, much additional work needs to be done, particularly in ensuring that IRS progresses toward its goal of incorporating performance management principles into day-to-day management. These principles include establishing performance goals, which are broad statements of desired outcomes; objectives, which are targets that describe the end results to be accomplished in a given period of time; and performance measures, which are used to gauge progress. Further, IRS expects its managers and their work groups to routinely analyze data to determine whether they are progressing as expected toward achieving the desired results.

Key Accomplishments Over the Past Year

IRS' key accomplishments over the last year include the following:

- In October 2000, IRS largely completed its transition to a new organizational structure centered on four customer-focused operating divisions.[17] In a process that the Commissioner likened to putting together a giant jigsaw puzzle with literally thousands of pieces, IRS put the new organization in place without significant effect on its processing of millions of returns this filing season.
- In January 2001, IRS published a strategic plan for fiscal years 2000 to 2005. In laying out the IRS mission, strategic goals, and objectives, the plan is consistent with the management principles contained in the IRS Restructuring and Reform Act and GPRA. The plan also documents IRS' intent to achieve the balance between service and compliance that Congress

[17] The operating divisions are (1) Wage and Investment, for individual taxpayers, headquartered in Atlanta; (2) Small Business/Self-Employed, for fully or partially self-employed taxpayers and small businesses with assets of less than $5 million, headquartered in New Carrollton, MD; (3) Large and Mid-Size Business, serving corporations and partnerships with at least $5 million in assets, headquartered in Washington, DC; and (4) Tax-Exempt/Government Entities, serving government entities, exempt organizations, and employee plans, headquartered in Washington, DC.

sought in the restructuring Act through a balanced set of goals, associated objectives, and measures. We believe that they represent progress, especially at the organization-wide level, in the challenging task of revamping IRS' performance management system.[18] Critically, IRS has not approached this strategic planning process as a mere paperwork exercise. Instead, the Commissioner and senior staff have been very much involved in the strategic planning process and intend that the strategic plan be a guide to transforming IRS.

- Recognizing that the entire institution must understand and adhere to organizational goals, IRS is continuing to move forward in driving a standard performance management system throughout the agency. For example, IRS implemented a strategic-level planning and budgeting process designed to reconcile its many critical and competing priorities and initiatives with the realities of its available resources. In addition, IRS has substantially developed a set of organizational performance measures for the goals and objectives in its strategic plan. Last year, IRS also made progress by aligning its performance evaluation system for managers with its balanced measurement system, to clearly link their work to the mission and goals of the agency. Further, IRS is beginning this year to hold managers accountable with a performance-based pay system.

Improved Taxpayer Services and Compliance Activities Hinge on Completion of Management Improvements

The progress IRS has made in reorganizing into taxpayer-focused divisions and in instituting its performance management system, while notable, is incomplete. IRS must follow through by

[18] *IRS Modernization: IRS Should Enhance Its Performance Management System* (GAO-01-234, February 23, 2001).

completing the framework it has established and designing and implementing business practice changes that result in improvements that taxpayers can see. Examples of the continuing challenges facing IRS in instituting its new performance management system include the following:

- The performance management system is most fully developed at the organization-wide level, is less well developed at the division level, and is weakest at the front-line level, where interactions with taxpayers occur. IRS' performance management plan calls for each operating division to have complementary goals, objectives, and measures, and for front-line managers to develop plans identifying the actions they need to take to support operational objectives. While, at the division level, we found that most goals were clearly stated,[19] most operating objectives were not specific, measurable, or outcome- or output-oriented. Further, a large number of operating measures and indicators were not directly linked to objectives. The action items in the plans developed by front-line managers were clearly stated and consistent with IRS' mission, but 91 percent of the items we reviewed were not specific, measurable, and outcome- or output-oriented.
- While IRS has revamped its evaluation system for managers, it still needs to similarly align its evaluation system for front-line employees. This will require tailoring the performance standards for employee groups to what is appropriate and measurable in their units, and to align those performance standards to encourage behavior that contributes to the three strategic goals. IRS intends to have this evaluation system implemented by October 1, 2001.

[19] Goals should (1) clearly articulate the divisions' future direction, (2) indicate the expected impact of achieving the goal, and (3) provide a clear basis for establishing objectives.

- Although IRS has recognized the need for information to assess whether its various methods of encouraging voluntary compliance with our tax system are achieving results, it has not yet developed a plan for obtaining that information. IRS has experienced a significant decline in the use of tax collection tools, such as liens or levies. Similarly, the audit rate for individual taxpayers has declined precipitously over the past several years. These declines raise concerns that taxpayers' confidence will be shaken in the voluntary compliance foundation of our tax system, which could adversely affect overall compliance. For instance, voluntary compliance could suffer if taxpayers come to believe that others are not paying their fair share of taxes. On the other hand, IRS continues to use other techniques to review tax returns for the accurate and complete reporting of income and tax liabilities. It also has increased emphasis on providing better service so taxpayers can understand their tax responsibilities and more readily comply. However, because IRS does not have a current measure of voluntary compliance, it is unable to assess the net effect of these factors on the level of voluntary compliance and how best to improve compliance levels. In part because IRS lacks these fundamental data on compliance levels, we consider unpaid taxes of which IRS is or is not aware to be a high-risk area.[20]
- Reorganization has provided a focus on taxpayer segments with the expectation that this will enable IRS to better understand taxpayers' needs and to modify its systems and procedures for interacting with taxpayers. Because the reorganization has just been completed, IRS generally has not yet identified those changes in its systems and procedures that may better serve taxpayers.

[20] GAO-01-254, January 2001.

Managers Would Benefit From Use of Performance Management Principles in Making Programmatic Decisions

Although managers are vital to translating IRS' goals and objectives into actions that make a difference, they have not consistently revised their programmatic decisionmaking in line with performance management principles. The following examples illustrate our concern that managers often do not adhere to these principles:

- As mentioned, front-line managers' action plans developed to support operational goals were the weakest link in the overall performance management system. The lack of guidance to managers about how to develop this initial round of action items may partly explain the problems. Nevertheless, unfocused and unmeasurable plans could be a significant impediment to IRS' intent to align managers' and core employees' performance expectations with organizational goals and objectives and to hold them more explicitly accountable for helping IRS achieve them. The very high portion of action items that were not specific, measurable, or outcome- or output-oriented also raises concerns about whether managers are yet adhering to IRS' performance management system.
- In the telephone service area, IRS lacked long-term goals for the level of telephone service to be provided to taxpayers, as well as annual goals designed to make progress toward achieving long-term improvement.[21] Such goals are essential for guiding the development of strategies and the identification of resources needed to achieve substantive performance improvements. Further, IRS has made several changes to the performance measures that it

[21] *IRS Telephone Assistance: Opportunities to Improve Human Capital Management* (GAO-01-144, January 30, 2001).

uses for its telephone service operations and, while each may have merit, the lack of continuity in performance measures may undermine IRS' ability to identify performance trends and factors that may be influencing those trends.

- Finally, as mentioned, IRS' financial management systems fail to provide the real-time cost data that managers need in order to make informed decisions about the efficiency of their programs and appropriate staffing levels.

BUSINESS SYSTEMS MODERNIZATION

We turn now to business systems modernization (BSM)—IRS' multiyear program to put in place the technology that will support revamped business processes. This multi-billion-dollar program, which began a little over 2 years ago and has thus far received congressional approval to obligate about $450 million,[22] is vital to achieving IRS' new, customer-focused vision and enabling it to meet performance and accountability goals. BSM consists of a number of new systems acquisition projects that are at differing stages of being acquired and implemented, as well as various program-level initiatives intended to establish the capacity for IRS to effectively manage the projects.

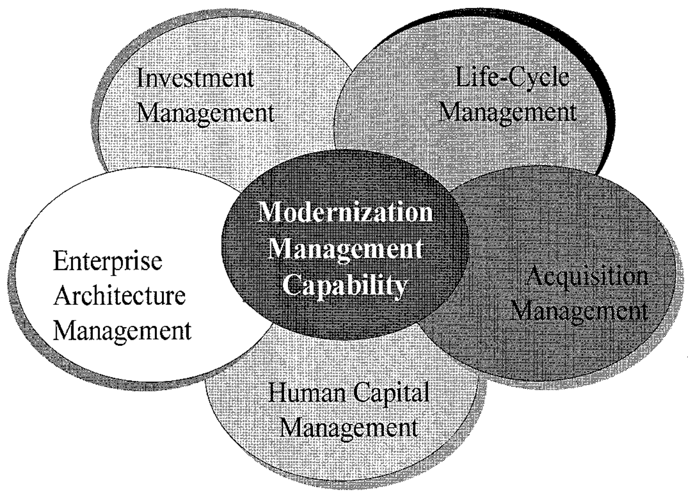
[22] IRS requested and the Congress established a multiyear systems modernization account and funded it with approximately $578 million via IRS' fiscal year 1998, 1999, and 2001 appropriations acts. To date, IRS has received approval from the Congress to obligate about $450 million from the account.

We have long held—and communicated to IRS—the importance of establishing sound management controls to guide its systems acquisition projects; to its credit, IRS has made important progress in this area. Nevertheless, IRS is starting to let project acquisitions get perilously ahead of controls—proceeding in some cases with detailed systems design and development without having the capacity in place to help ensure that projects perform as intended and are completed on time and within budget. We remain concerned that at these later stages in systems' life cycles, the risk of rework due to missing modernization management controls increases, both in terms of probability and impact. Given that IRS expects to totally exhaust most of the congressionally-approved BSM funding by mid-November 2001, and thus is seeking additional money for fiscal year 2002, this is a good time to ensure that the overdue modernization management controls are emphasized as a BSM priority.

Beginning in 1995, when IRS was involved in an earlier attempt to modernize its tax processing systems, and continuing since then, we have made recommendations to implement fundamental modernization management capabilities before acquiring new systems; we concluded that until these controls were in place, IRS was not ready to invest billions of dollars in building modernized systems.[23] While IRS has since taken steps that have partially addressed our set of recommendations, important ones remain unfulfilled to this day. In general, the areas in which we found controls to be lacking and made recommendations to fill these voids fell into five interrelated and interdependent IT management categories, as shown in figure 2—investment management, system life-cycle management, enterprise architecture management, software acquisition management, and human capital management.

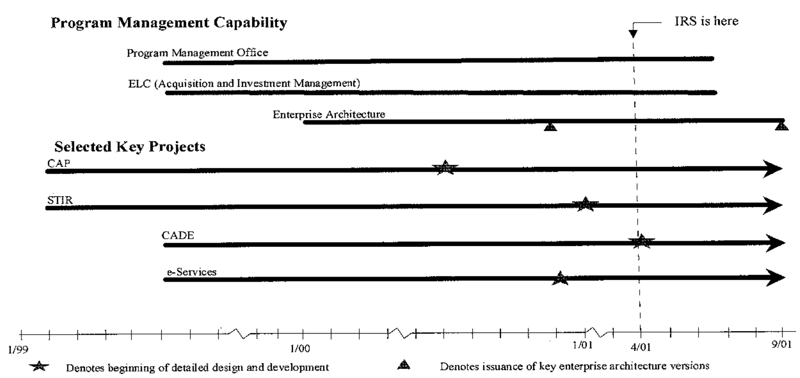
[23] *Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed* (GAO/AIMD-95-156, July 26, 1995).

Figure 2: Categories of Management Controls Needed for Modernization Capability.



In December 1998, IRS hired a systems integration support contractor to, among other things, help it develop and implement these program capabilities. Subsequently, the Commissioner adopted a modernization strategy that appropriately required, for example, (1) the use of incremental investment decisionmaking, (2) adherence to a rigorous systems and software life-cycle management method, and (3) development and implementation of an enterprise architecture or modernization blueprint to guide and constrain the content, sequencing, and integration of systems investments. This approach, however, included the simultaneous development of these kinds of program-level management capabilities while also proceeding with project acquisition, in anticipation that program controls would be in place and functioning when these projects reached their later, less formative stages. Figure 3 illustrates this approach.

Figure 3: Concurrent Development of Program-Level Controls and Projects.



During BSM's first 18 months, progress in implementing these management controls was slow, while at the same time project acquisitions moved rapidly. At that time we reported to IRS' Senate and House appropriations subcommittees that projects were getting ahead of the modernization management capacity that needed to be in place to manage them effectively—the cart was getting ahead of the horse. In response to our concerns and the subcommittees' direction, IRS appropriately pulled back on the projects and gave priority to implementing needed management capacity.

Despite this shaky start to the modernization, IRS has since made important progress in its modernization management capacity. For example, last year we reported that IRS (1) largely defined and implemented its system life-cycle methodology that incorporates software acquisition and investment management processes, (2) defined program roles and responsibilities of IRS and its modernization contractor and began relating with the contractor accordingly, (3) began formally managing modernization risks in an effort to proactively head off problems, and (4) made progress toward producing the first release of its enterprise architecture.[24]

In addition, we recently reported that IRS had taken steps to address our recommendations aimed at strengthening management of individual BSM projects.[25] For instance, it started to manage the Custodial Accounting Project[26] as an integral part of the modernization program. On another project, the Security and Technology Infrastructure Release,[27] IRS assessed security threats and vulnerabilities, analyzed the resulting risk in terms of probable impact, and planned to reevaluate project requirements in light of this risk analysis. Recently, IRS hired experienced technical and

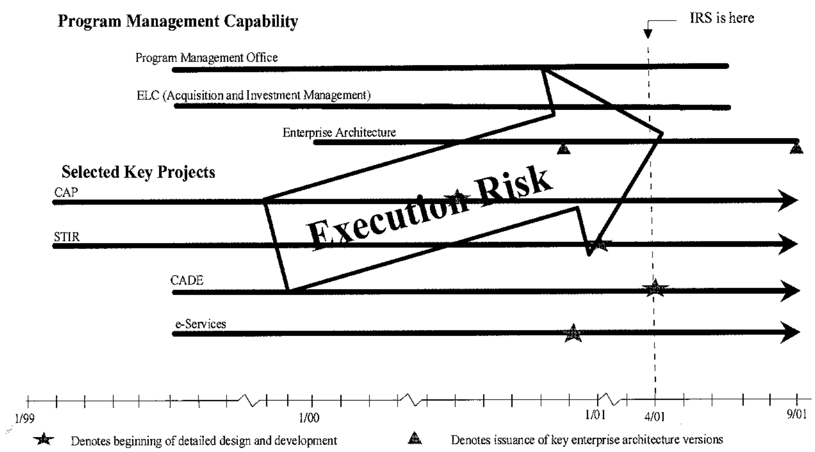
[24] *Tax Systems Modernization: Results of Review of IRS' Third Expenditure Plan* (GAO-01-227, January 22, 2001).
[25] See, for example, *IRS' Custodial Accounting Project* (GAO-01-444R, March 16, 2001) and GAO-01-227, January 22, 2001.
[26] CAP is expected to provide a single data repository of taxpayer accounts and tax payments as well as related tax revenue accounting and reporting capabilities. IRS also plans for CAP to, among other things, automatically reconcile accounts and payments, post updates to IRS' general ledger, and produce revenue accounting reports.
[27] This project is the common integrated infrastructure to support and enable modernization business systems applications. As designed, it consists of a combination of custom and commercial off-the-shelf software, hardware, and security solutions, integrated to form the technical foundation upon which modernized business systems applications will operate.

managerial executives, and augmented existing modernization staff with experienced IRS information systems personnel.

We are concerned, however, because projects are entering critical stages without certain essential management controls in place and functioning. In particular, in our ongoing work for IRS' appropriations subcommittees, we found that IRS is proceeding with building systems—including detailed design and software development work—before it has implemented two key management controls. First, IRS has yet to develop a sufficiently defined version of its enterprise architecture to effectively guide and constrain acquisition of modernization projects. Second, it has not yet implemented rigorous, disciplined configuration management practices. Both of these are requirements of IRS's own systems life-cycle methodology and are recognized best practices of successful public and private-sector organizations. This increases the risk of cost, schedule, and performance shortfalls. We have discussed these missing controls with the Commissioner and his BSM executives; they have stated that they plan to have them in place by the end of this June.

Timing is critical. While the lack of controls can be risky in projects' early stages, it introduces considerably greater risk when these projects enter design and development. To mitigate this added risk, IRS needs to fully implement the remaining management controls that we have recommended. Figure 4 illustrates the growing risk that accompanies project development in its later stages.

Figure 4: Increasing Risk Associated With Inadequate Controls at Later Stages of Project Development.



The timing of this hearing is appropriate for ensuring that IRS implements the remaining needed modernization management controls. While the Congress has appropriated about $578 million for the program to date, it also took steps to limit the agency's ability to obligate funds until certain controls were in place by establishing a multiyear capital account—the IT Investments Account—to fund IRS systems modernization initiatives. IRS has received about $450 million of this total, and has submitted a plan to the Congress to spend the remainder over the next 7 months. In addition, IRS plans to include $396 million in funding for BSM in its upcoming fiscal year 2002 budget request. This is, then, an opportune time to ensure that the agency addresses these outstanding risks as a condition of future funding.

CONCLUSION

Change is never smooth, easy, or quick. We understand that the four areas that we have discussed are part of IRS' decade-long effort to transform itself into a more reliable, accountable, customer-focused organization. It has clearly made important progress toward that end. We have made many recommendations over the years to assist the agency in this goal, and several have been implemented. We have worked closely with IRS officials, and will continue to do so.

As IRS moves forward from building the foundations for change to implementing new processes and systems that directly improve service to taxpayers, the potential rewards grow, but so does the risk of failing to realize the transformation everyone desires. Our theme today is simple. Make sure the foundation is strong so the structure will endure. Yet while building the new, don't neglect to maintain and make prudent near-term improvements to existing systems and processes.

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Mr. Chairman, that concludes our statement. We would be pleased to respond to any questions that you or other members of the Subcommittee may have at this time.

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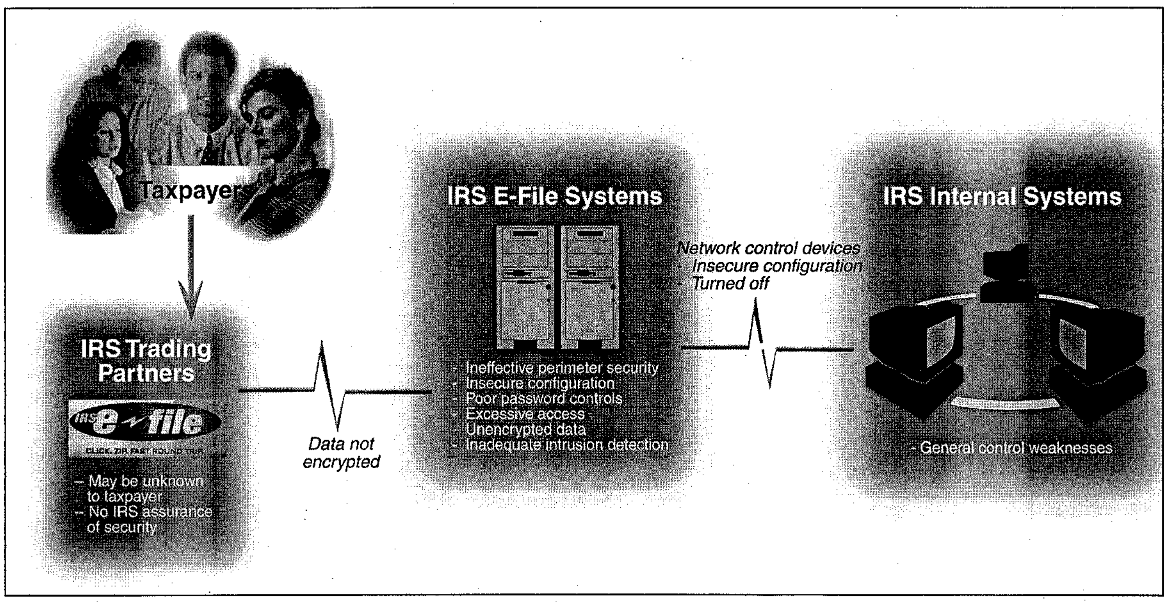

From *Internal Revenue Service: Progress Continues But Serious Management Challenges Remain* (GAO-01-562T, April 2, 2001), p. 8.

Mr. HORN. Before we go to questions, let me straighten out something that happened earlier today. In the Washington Post it said, "debtor's Social Security checks to be garnished." The Federal Government is owed more than $50 billion of delinquent nontax debts. The Federal Government has an obligation to taxpayers to pursue individuals who are unwilling to pay their debts to the Federal Government. For years, the government has been attempting to collect this debt through a variety of mechanisms.

The Debt Collection Improvement Act of 1996, which I authored along with Ms. Carolyn Maloney of New York, and which passed with overwhelming bipartisan support, gave the government additional tools to collect those delinquent debts. Among its various provisions the law allows the Department of the Treasury to withhold a portion of a delinquent debtor's Social Security benefits to satisfy their delinquent debt owed to the executive branch of the Federal Government. The authority to offset these payments can only be used as a last resort.

The delinquent debts that are owed are more than 6 months delinquent, oftentimes much more than 6 months delinquent. The Federal agency that is owed these debts has made every effort to work out a repayment agreement. Finally, the Treasury Department's Financial Management Services has contacted the debtor to attempt to work out a repayment agreement.

For this collection tool to be used, the debtor truly has no intention of repaying their debts. That is unfair to taxpayers as well as to those who are repaying their obligations to the Federal Government.

Those with disabilities as well as others under the Supplemental Security Income program are exempt from this collection program. In addition, to prevent undue hardship, the first $750 of the recipient's check is exempt. In other words, recipients who receive $750 or less will not be targeted. Only 15 percent of the amount above the $750 threshold will be collected. This percentage will be withheld until the debt is paid. This is a responsible and fair mechanism for the government to collect debt that has irresponsibly gone delinquent.

So, I thought we ought to clarify that, because the authority is in the agency involved.

I don't know if the Commissioner or Mr. Dacey wants to say anything or not. I don't know if you have ever looked——

Mr. ROSSOTTI. Just to say I think your summary was correct. We are at the present time—that's called the Federal payment levy program. We are currently levying on Federal vendor payments and Office of Personnel Management retirement payments, and there is a plan to extend that to some portions of Social Security payments as authorized by law beginning next fiscal year, October of this year.

Mr. HORN. Very good. I think people that have a problem, there are waivers. But, basically, what started me on this whole thing was, under your predecessor where the IRS had $110 billion that they hadn't collected anything on I was told, "oh, well, we've got another one that's $60 billion," and they weren't collecting on that. And they weren't organized.

Since we're now into question time, let me just ask the Commissioner what kind of an apparatus does he have to get at the pileup that's often coming out. And if you could just outline, are you getting new people in that area, are you using private debt collectors, or what in particular are we doing to get some of this down?

Mr. ROSSOTTI. As we've discussed at previous hearings, collection is one of the main things that the IRS does.

Mr. HORN. Turn the——

Mr. ROSSOTTI. Collection is certainly one of our main missions. Unfortunately, it's also one that I think, as we've also discussed, is quite far behind in the way this process works. The key problem being that the speed of collection that we currently pursue is very, very slow by comparison with the private sector. Typically, you know, it might take us 2 years not to collect all debts but in many cases it might be over a year, 2 years. The majority of our efforts are at the back end of the process.

Our long-term vision, which is now well documented in the overall enterprise architecture, is to try to bring that down to 6 months, which we think will not only increase the probability of collection, we know it will, but also in a funny way we'll reduce the burden on taxpayers. Because if you wait that long to collect, the interest is built up; and it's harder for people to pay. So that's our vision.

As with everything else, just as I said in my statement, we have to do some things now. In fact, most of the things in this area really depend on new technology. But there are some things that we can do. And mainly what we're doing is we're trying to do some modest reengineering of the collection process in the short term to do better workload selection so we can assign the right cases, or better yet, do a better job of assigning the right cases that really have collection potential and less emphasis on those that don't. Because, we simply don't have the resources to collect everything. That's a sort of a primary short-term issue.

We are going to be using some of the resources from our 2001 budget to provide more staff resources, and we're going to do that in two ways. One way is by directly putting some more staff onto the phone collections, especially. But, the other way is by putting some more people into customer services and customer education positions so that they—and they will be generally not as expensive as our collection people, will be able to handle the filing season duties and we will not have to pull as many people as we have done in past years off the collection cases to staff the filing season, which was a necessary response to provide some services during the filing season but is really inefficient and in fact debilitating to the collection process because you're putting off case work, and making it even slower than it would be.

So the two short-term things are providing additional staffing in, we think, an intelligent way where we can do better workload selection. Then the longer term is really the major modernization program.

Let me just mention one—we've talked about this in the past. In your hearings last year I remember the chart; and we said, this is what we want to do, here is where we are. We kind of knew at a high level where we wanted to go. The one really big thing that has been done on that score since the last time is that, through that visioning process, this enterprise architecture, we now have a much more established, clear vision of what the future state of IRS collections would be; and that is the guideline that we're going to—we hope to, later this year, assuming we get the funding release from Congress, to really begin in a serious way the initial design work on that program. It will still take several years before the first implementation of it, but it lays out the vision in a fairly clear way, and it also does what we've talked about at a more general level, which is to try to quantify what we can do with this.

We believe we can significantly improve our ability to address all of the collection issues that we currently have, which we can't do now because of resources. We will need a little bit more resources, in terms of staff, which we can get by redeploying from other functions mostly. But, mostly it will be through the support of the additional technology.

Finally, not to go on too long on this, but one of the other things that has been key in the Congress's view, I think Mr. Putnam notices this in the collection area, is protection of taxpayer rights. A lot of RRA was about taxpayer rights. We have implemented all of the provisions of RRA with respect to our current collection process. But, a lot of it relies on training employees to remember to do this, to remember to do that, to check off a sheet, to do things manually.

We intend in our future collection vision to have all these taxpayer rights built in to make it—I will never say foolproof because I have learned that there is no such thing as foolproof when people are doing things, even with computers—but, essentially build right into the process that the computer has control so it will be very difficult, if not impossible, for somebody to violate taxpayer rights, for example to try to execute an enforcement action before the time has expired for the person to get the notice of their appeals. Those are very doable things that we can do.

We tried to jerry-rig them as best as we could with our existing systems, but these systems are limited. So, I think we have a really major opportunity to dramatically improve our ability to collect money, reduce the burden on taxpayers, protect taxpayer rights, and improve efficiency, all at the same time. It will require some investment.

Mr. HORN. Well, to what degree are you going to use private debt collectors? That would cut down your request for a budget increase. The last I knew, a lot of bill collectors were pretty effective and get the job done; and I don't see that really being used very much. Just how many collectors do we have now that are private?

Mr. ROSSOTTI. That are private?

Mr. HORN. Yeah.

Mr. ROSSOTTI. We're not using private debt collectors right now. I think we have talked about this before. There are some with the computer systems we have. In order to effectively use private or public debt collectors, you have to provide the people clear, accurate information about what you're collecting, about what needs to be collected, and about the history of the people that you have tried to collect on. That's what we don't have.

I think we did an experiment once before, before I got here, and I have looked at that. I know that the people who worked on it on the private side thought they were given garbage collections to do.

Mr. HORN. The problem under your predecessor was that when they had this great pilot project, it was 5-year-old debt which they hadn't done anything about to start with, and now they wanted to dump that on a private debt collector. It just didn't work. It was a phony operation. That sent me right through the ceiling. I don't understand why we can't get private debt collectors. If the Federal Government—they ought to be—you ought to be training the people so they can have a higher level job, I would think, in terms of working and interacting with the taxpayer.

Then I had a lot of nonsense about, oh, it's a privacy problem. There is no privacy problem. Give them the address, tell them how much, and if they say I don't owe that, they say, "fine, here's an appointment with a revenue officer, maybe you can work it all out." But, I just think—I can't believe we're still not moving ahead to get private debt collectors.

Mr. ROSSOTTI. And I think that, again, that is something that we have discussed, to try to—notwithstanding some of the issues about how old the debt was that was given in the previous pilot, if we were to attempt to do it today, with the best intentions, we would still have two fundamental constraints, which is most of the debt we're collecting on is very old, just because of the nature of our inventory; and, second, the systems—that we have to get accurate and current information is a fundamental requirement to do accurate collection. You have to know who you're collecting on, what you're collecting on, and history, which is precisely what we lack because of our computer systems.

So, if we were to do it again, even with trying to improve it, we would run into some of the same issues, maybe not as bad as last time.

I think that as we move forward with this vision that I talked about there are some elements that it might be very possible—assuming we can work out the systems issues and the other contractual issues, it might be possible to provide a portion of that inventory that could be part of the solution to dealing with this inventory as we move forward.

Mr. HORN. Well, I would sure hope we can be a little more efficient on that side, because I think it's an outrage when all the rest of us pay our taxes and these people sit there and get away with it.

We've recently had a thing related to pardons, for example. I'm taking about big fat cats, the ones that do it repeatedly, that go out of business and, say, "oh, sorry, we're all bankrupt." Then they're back in 2 days or they have the name changed or something. Meanwhile, everybody else is paying their taxes and these guys aren't. That bothers me. Does it bother you?

Mr. ROSSOTTI. It does. It's one of many things about the IRS that bothers me right now.

Mr. HORN. How are we going to deal with it then?

Mr. ROSSOTTI. I really think that the key thing that we have to do—and the computer systems really are part of this, because you can't collect debt effectively, no matter whether it's private or public, without having accurate, up-to-date, timely information about who is likely—who is delinquent, what the probability is of their going further delinquent, and so forth. Any private debt collector has to have that. That's what we lack. That's one of the reasons why it's so slow. I think the solution is——

Mr. HORN. Is OMB giving you the money this year.

Mr. ROSSOTTI. There is $397 million in the President's budget request for the ITIA account, which is very significant. It's probably the most significant.

Mr. HORN. Million or billion.

Mr. ROSSOTTI. It's $397 million for 2002. That was in the blueprint that was published earlier by the administration, and that's an important step.

Mr. HORN. I'm sure that you'll be provided that. So, you think that will help bring this pile down.

Mr. ROSSOTTI. We've just finished this whole exercise. One of the key projects is this whole collection project. I wish I could tell you that there was a quick way that we could just deal with this and, if there were, you know, we would be doing it, I can assure you. It wouldn't involve private debt collectors or anything. I really don't think that there is a quick solution to this. I think there's a solution. I don't think there's a quick solution.

Mr. HORN. Well, I think you're right. When they didn't give them any notices and pretty soon somebody says, "oh, gee, I remember getting a grant from the Federal Government," and they don't think of it as a loan. Students are the same way, and we expect bankers to collect the debt.

But, bankers don't because the law, which was written long before my time, you know, states that if they default, they get paid by the government anyhow. That's just a recipe for absolute stupidity, and maybe we oughta tighten that one up, too. The gentleman from Florida, Mr. Putnam, any questions?

Mr. PUTNAM. Mr. Chairman, I appreciate the opportunity to be a part of this hearing. Let me just ask you a couple of basic questions for the slow learner on the group. What percent of returns are prepared by taxpayers themselves versus professionals?

Mr. ROSSOTTI. About 45 percent on individual returns.

Mr. PUTNAM. And how many employees do you have currently?

Mr. ROSSOTTI. Employees, we have, well, about 100,000 equivalent employees, including averaging the seasonals in there.

Mr. PUTNAM. Do you know what the estimated accounts receivable are, or debts owed to the IRS?

Mr. ROSSOTTI. Well, in the financial statements which GAO prepared, there's what's called the net accounts receivable, financial accounts receivable in here is about $22 billion. That is net of——

Mr. PUTNAM. $22 billion?

Mr. ROSSOTTI. $22 billion. That's net of, you know, estimated allowances for bad debt losses. The gross receivables are more than that. I think they're around $80 billion, if I recall correctly. I've got this number here, but the—that's really the total inventory that we can conceivably collect on. Obviously, we're not going to collect it all, but the financial statements really net it out down to about $22 billion. That is estimated.

Mr. PUTNAM. And what is your average turnover rate among your employees?

Mr. ROSSOTTI. The turnover rate? Well, you have to really break it down between full-time, or let's call them permanent employees, and seasonal. We have a lot of seasonal employees that work during the filing season, which is what we call the period before April 15th. There are about 80,000 permanent employees of the IRS, slightly more than 80,000, and the turnover rate, I would have to get that for you. It varies by job classification. I believe that it is around 4 percent right now, 4, 4½ percent.

So, it would be about 3,500 employees leaving every year, of the permanent work force. The seasonals, it's not quite the same kind of a calculation because they're coming back to some degree year after year, but they're also only working part time.

Mr. PUTNAM. The observation that I make based on—I mean, I take that as a very low turnover rate.

Mr. ROSSOTTI. It is relatively low.

Mr. PUTNAM. They're obviously well compensated, fairly satisfied with their job. Otherwise they would be fleeing in an economy like this, I would observe. Is that not correct?

Mr. ROSSOTTI. Well, I think that it is interesting. It is a relatively low turnover rate compared to what I had in the private sector, and I think what it reflects—and I have studied this quite a bit—I don't think you would get agreement from our employees that it's because they're all very happy and feel they're well compensated. I think the reality is we have a very aging work force. A substantial percentage of our work force is getting to the point where in 5 years—I think—I don't have the exact numbers, but many job categories, half the people will be eligible to retire in 5-years, or 40 percent.

What happens in the Federal Government, partly because of the way the retirement system works, is once people get in and stay a certain number of years, they tend to stay in until they can get to the retirement program, and I think that has been very helpful actually in terms of keeping our work force stable.

What it means, though, is that we're looking at a very serious problem. I think GAO has made a lot of notes of this across the whole Federal Government—as a key point, I know that Mr. Walker, the Comptroller General, has been focused on that we have this bubble coming up where a very substantial percentage of our skilled employees, especially, are simply going to be leaving, you know, in the next 5, 6, 7 years.

The reason that this situation exists is because in the IRS, among the permanent work force—forget the seasonals for the moment—there has been minimal hiring since 1995. I mean, one of our key occupational classes in the IRS is what's called the revenue agents. Those are the most skilled people—actually, the accountants that go out and audit corporate returns and more complex returns. Because of the budget limitations, and essentially the near hiring freeze we've been in, until this year, until 2001 when we got money, there was virtually no hiring.

I mean there had been virtually no revenue agents except for a handful hired since 1995. So, you know, even though the people that are there are staying, every year they get 1 year closer to retirement, and we are now in a position where we have a substantial percentage of these folks that are getting close to retirement.

So fortunately, in the 2001 budget, we did get some money and we've begun to resume our hiring program, and in fact, you will see some advertisements on the Internet and other places, on college campuses, the IRS is going out and hiring for the first time.

Mr. PUTNAM. Do your employees have the training and the professional development that they need to deal with these technologies that you are moving toward, and are they prepared to make the most of our IT investment?

Mr. ROSSOTTI. That's an excellent question. And I think maybe the answer is not one that you would expect or that I would have expected. You know, having come from the private sector, one of the ironies of the IRS is it was one of the first organizations of a large scale to make use of computer technology on a pervasive basis. I mean, you know, the systems, some of them we're using were built in the 1960's. So actually, compared to many organizations, our front line employees are very literate in terms of using computers, or they're very used to using computers.

As a matter of fact, if you were to look at what some of our employees who answer the phones in customer service do with the 30-year old systems they have, which are much harder to use than the systems that exist today, much harder because they require entering little codes, they are really quite adept at it. So, our employees are dying for this new technology. They're not resisting it. That doesn't mean they don't need training. They will need training, not so much in the use of computers, because they're really quite used to doing this, but rather in the new business practices that we are going to be able to establish.

For example, in our collection area, we're going to be changing, as I said to the chairman, the whole way we do business. So, that part of the training is where the training is going to come up. But, in terms of just basically enabling people to use computer technology, we have a surprisingly adept work force in using and being resourceful in using what are really quite difficult systems to use.

Mr. PUTNAM. Is there an incentive in place, or is there a disincentive in place to—for your agency to retain a portion of old debt or collections that can be reinvested in your agency, in IT or in professional development or whatever your needs may be—let me be very careful in how I phrase it—without an incentive for a quota system, but certainly an incentive to retire these old debts, collect them?

Mr. ROSSOTTI. Well, I think just to clarify, in terms of the way the financial model works, we don't retain any revenues that are collected. I mean, we are an agent of the Federal Government, and all of the revenues, every penny that is collected from the taxpayer, is turned over to the Treasury, you know, directly, and we have to account for it.

There's one minor exception. There's about $70 million of what are called user fees that we're allowed to impose for certain kinds of services that we provide, but with the exception of those user fees, you know, the entire $1.8 trillion that we collect net is turned over. So there's no incentive or disincentive in a financial sense.

Now, on the other hand, with respect to what we do, I mean, our mission and our goals are basically, as I related them, one of them, is fair and efficient—fair application of the tax law to every taxpayer. We've translated that down into a series of measurement systems we call a balanced measurement system, which in the debt area, has to do with respecting taxpayer rights, you know, closing cases on a quality basis. It does not involve dollar factors, though, because under section 1204 of the Restructuring Act, the IRS is not allowed to use dollar quotas or what are called "records of enforcement results" to set goals or evaluate anybody.

As a matter of fact, as I sometimes point out, the oversight board can't evaluate the commissioner based on how many dollars we collect either, because I'm an employee of the IRS.

But all joking aside, the way that we have to measure performance in the IRS is very much not focused on dollars any longer, but in terms of effective execution of our plans, quality casework and the amount of cases that we process but not based on any kinds of dollar figures.

Mr. PUTNAM. Mr. Levitan, in your testimony—and welcome as a fellow Gator, glad to have you—there was—for the first two-thirds of your testimony, I was ready to loan you a gun and just go ahead and put the agency out of its misery. You identified that they do not provide quality service to each taxpayer in every interaction as they have identified in their strategic plan; the agency does not provide top quality service through fair and uniform applications of the law; nor does it provide productivity through a quality work environment. How much of an investment are we going to have to make in people or computers, and if you would, please clarify for me, we've—you've identified an additional staffing requirement and additional technology requirements. Is there a way that we can invest in one and save on the other?

Mr. LEVITAN. First, the investment will be long term and it will be significant. And in the long term, you will save on personnel and operating costs by making the investment in the new technology and the new business processes. The modernization program will probably last somewhere between 7 and 10 years. It will just take that long to get it completed. It's entirely too long. Everyone would like it to move a lot faster than that, but there is so much that needs to be done, the systems are so large and complex and interrelated with each other and with the existing systems, and just the management ability of the IRS to manage all of that change will require it to take that long a period of time.

The IRS has developed a very detailed plan on how that investment should be made, what should be done, when it should be done, how long it will take, and what the benefits are. The Commissioner talked about—mentioned that the President's budget includes a recommendation for $397 million to be put into the information technology investment account. The Oversight Board recommends that the budget for 2002 for ITIA not be $397 million, but should be $1 billion, and we think that there are very strong reasons for it to be that much.

First, the biggest part of it is that we're recommending that the account be funded for a 2-year period of time. The $1 billion would cover planned expenditures for both 2002 and 2003. When ITIA was originally established, one of the major reasons to set up the account that way was to provide continuity of projects and funding for projects that will last over fiscal year periods of time, and so you do not reach a point in time that you know you run out of funding, that it goes to zero. You have to artificially slow down or start projects in the next fiscal year.

Initially the account was funded on that basis. Unfortunately, by the end of this fiscal year 2001, and for the first time that the account has been in place, it will be down to zero. That's a dangerous situation. It can be a highly inefficient situation. So, we are recommending that 2 years of funding be put into it.

Second, our recommendation is that funding be set up for $450 million in 2002 and $550 million in 2003. So, there is a difference between our recommendation and the administration's recommendation of something like $53 million for 2002. You might say, well, $400 or $397 or $400 million is an awful lot of money, and it certainly is, but the IRS has detailed plans in place of what needs to be done, and the price tag on it, if they do it all in that period, would be about $450 million. If only $400 million is appropriated it will take a program that is already taking too long and it just extends it out further than that.

So, again, it's going to be a long-term investment. It will be over the next 7 to 10 years, but by making that investment, you have the capability to create a completely different IRS, an IRS that is much more efficient, an IRS that serves the taxpayers much better, an IRS that collects a much, much higher percentage of the taxes that are due to the Federal Government.

Mr. PUTNAM. Where would the bulk of that modernization money be spent? At the customer service level? At the collections level? At the audit level?

Mr. LEVITAN. Really, on all of those things there are a large group of new systems. First of all, what needs to be done is we need a technology infrastructure put into place. That technology infrastructure includes new communications, the kind of improved security that you've heard talked about, and the need for that described earlier. It includes new data bases which would have current, up-to-date, consistent data about all taxpayers, about all tax returns, so it could be made available, both to the taxpayers that need that information themselves, as well as the employees that are providing both service to taxpayers, as well as following up on the enforcement activities. So it's all of that.

One of the first things I did when I first started working with the IRS is I visited a number of the centers. I had the opportunity to sit down with someone who was answering the telephone and trying to answer questions from taxpayers, and if you would do that, it's amazing. You're almost embarrassed at how poor the systems are, how poor the information is. The individual trying to answer the questions couldn't get accurate, up-to-date information in order to respond to the fairly basic questions that the taxpayers were asking, and because the systems are so antiquated they need to be replaced and put in.

But again, to answer your question, you know, the new technology would address all three of those primary objectives that the IRS has established in their strategic plan.

Mr. PUTNAM. Thank you, Mr. Chairman.

Mr. HORN. I thank the gentleman, and let me ask on a follow up on that. Commissioner, you're an expert in dealing with computers. Are we already too far down the path or could you use the money if Congress took the recommendation of the chairman of the Oversight Board, or are there other things——

Mr. ROSSOTTI. Oh, could we use the money, I feel certain we could use the money. I think, you know, as with any agency head, within reason, if we had more we could do more. So yes, I believe that we could use the money. I will say that the way the ITIA account works, and I'm cognizant of what the GAO testimony was, which we take very seriously, is that we don't want to get our projects ahead of our management capacity. So, we're constantly working on both of those, but I think we feel that within the bounds that we're talking about here we could manage it and we would manage very carefully.

The way this ITIA account goes, the money goes in and it's appropriated, but we don't actually get the money until we present a specific plan to Congress. Right now we have a plan for the second half of this year that is before the appropriation committees and it's being reviewed by GAO. So, even if the money is in the account, we're not going to be able to spend it, nor would we ask to spend it, unless we were sure, as we get closer to that period of time, that we would be prepared for that.

Mr. HORN. How much did we spend last year for modernization in your budget?

Mr. ROSSOTTI. Well, this is an interesting point. In the current fiscal year, there was only $71 million. I mean, I know that's a lot of money, but relative to what we're talking about——

Mr. HORN. $71 million?

Mr. ROSSOTTI. $71 million. However, we had $300 million of carryover funds from prior years, from the prior account. So assuming that if Congress, and the appropriation committees approved the release request that we currently have pending, which we're waiting to hear, but if they do, then with that money we will have essentially spent—you know, obligated about $370 million, which is all that we had. So, in other words, because of the carryover nature of this account, even though there was $71 million of appropriations, there is actually $371 million of funds available, taking into account what was carried over from prior years.

Mr. HORN. The carry over now is how much?

Mr. ROSSOTTI. About—little over $300 million.

Mr. HORN. $300 million. Well, that isn't chicken feed.

Mr. ROSSOTTI. None of this is chicken feed. It's serious money. It's serious money.

Mr. LEVITAN. Mr. Chairman, if you don't mind, I wanted to comment on talking about the size of the spend on the modernization. When you do major technology programs, they tend to start at a relatively small level and go up as they progress. You start with the planning phases of the project, you move into the design phases, and then you move into the development phases where you know you're making major acquisition of hardware and software and developing the new systems, and the costs go higher. There is a plan in place and what that—and we believe that the plan is reasonable. It needs to be managed every step of the way and oversight provided by our board, by Congress, by the GAO and others, but that plan shows the expenditure levels going from, you know, about 300 and so, $370 million in this fiscal year to $450 next fiscal year, to $550 in the following fiscal year and then peaking out for a number of years at about a $700 million level. So the numbers will continue to go up, and you should not be surprised at that. It's just the nature of the beast that we are trying to conquer here.

Mr. HORN. I was just checking my memory here. When I first came to Congress in 1993, I went out and looked at the Federal Aviation proposals and actions. They were doing all this wonderful computer design and everything about 20 miles out of town. There was absolutely no management, and then they went through a series of people and passed it on, and then IRS was also in modernization, but that was chaos, too, $4 billion down the drain, I think I remember right.

I asked both of them when we had them in, I said "how about stopping at $4 million, maybe $40 million, how about $400 million? Why do we always get the taxpayers' money going down the drain in some $4 billion thing where they haven't planned it out, managed it or done anything?" It was the stupidest operation I have ever seen in both of them. So what did we ever do with the $4 billion earlier, before you got there?

Mr. ROSSOTTI. Well, it was before I got there. I mean, that's my best answer. I think, you know, I don't really know whether it was $4 billion. I don't know exactly what it was. We have been looking for it. There were some deliverables that were realized out of that. It wasn't a complete loss, but clearly it did not solve the problem. I mean, that's an accurate statement. I mean, most of our fundamental systems were not replaced, and you know, we could go back and look at that, and I think there are some very fundamental reasons.

Just to tick off some of the things that we have now, and I don't mean by saying this to minimize the risk of this, because I think Mr. Levitan said, and you know I agree with this, that this is a high risk program. It's a very high risk program, and it's not a program that frankly I wish that we had to have the IRS do. You know, most organizations would never get this far behind, and they would never have to do a program like this. So, it's not something that you wished you had to do, but there is no real alternative. So, we have to manage it as well as we can. But just to tick off a couple of items.

First of all, from an organizational standpoint—this is most fundamental—the IRS had at least—when I got there, at least 15 different information systems organizations. There were many different units, and they all had their own CIO. The CIO had effective control only of the headquarters portion of that, not the whole thing. There was virtually no standardization of any technology. So, even if you had a system—and frankly, this was one of the problems—even if you had a new system that you successfully developed, it could take 10 years to deploy it because every place had a different standard. So, organizational standardization just in basic technology, that has largely been resolved.

Not all of the standardization has been fully implemented, but the organization structure for information systems is a centralized structure, all the resources are in one place, management is under one place. We have a new CIO that has recently just come in that I'd like to come up and introduce to you, former CIO of Time Warner Corp., very qualified individual, and we have some other people.

So, we have an organization in place. We have standardization close to being where we need it to be. We've set up a program management office to run the modernization program. We have a prime contractor with the resources of the private sector that has been brought in. We have a rigorous methodology in place. We have an enterprise architecture.

Now, as GAO constantly notes for us, and we agree with this, it's not a mature process. Not all of this is mature. It's not functioning at a level—I'll call it maturity—that it needs to be. For example, there is more work to be done to fill in some of the details in the enterprise architecture. We don't have all of our configuration management processes as well developed as they should be. I think the enterprise life cycle is approaching much more maturity, but I could go on and on with these things.

We are working constantly to increase the maturity level of our management processes at the same time we deliver. We can't put a fully mature management process in place for something this huge without actually doing some real projects. I mean, it would be like going into a sports team and just doing spring training all year around and never actually playing any games. You would never really learn. So, we have a constant challenge of maturing, increasing the maturing of our management processes at the same time we actually work on delivering these systems, and I think we're making some serious progress, but you know, every day that goes by we learn.

I will say to you, Mr. Chairman, that we are not in chaos. We are not just spending money without a plan, without management discipline in place. I view it, and I think all of my management team that's come in from the private sector, as well as those that have signed on to this, view it as though it were their own company. I mean, I don't want to spend a dollar on this program if I wouldn't spend it exactly the same way if it was my own company, and that's the way I feel about this program. I don't want to have anybody working on it that doesn't feel the same way.

Even under the best of circumstances, though, it is a high risk program. There's going to be some delays. There's going to be blind alleys. There are going to be things that are going to go wrong.

I will finally just finish up—and I know I may be going on too long with this—to say that even though it's high risk and we will make some mistakes along the way, you know, it does not follow from that this program is destined to fail. That is not the conclusion I'm saying. In fact, I don't believe that it will fail. I believe it can succeed and will succeed, and it will pay off enormously as long as we manage it intensely and we're not afraid to recognize when we have problems, back up and try something different, slow down and speed up depending on how much we learn, and just manage this on a sustained basis. It can succeed and I think it will succeed, and I think we know how to make it succeed as long as we stick with it and are not afraid to recognize the reality of what we're dealing with.

Mr. HORN. Well, I think that's good advice. Let's move to a couple of other things. Tax advocates. How do you feel about that program?

Mr. ROSSOTTI. The taxpayer advocate?

Mr. HORN. Yeah.

Mr. ROSSOTTI. Well, I think that is a program which has made a great deal of progress. We have established the taxpayer advocate service, as we now call it, as was required by RIA. So this is a distinct entity within the IRS that has its own line structure. Has about, a little over 2,000 employees. There's taxpayer advocates in every State. We have a new taxpayer advocate that has just come within the last month, and I'd like to bring her over to meet you, Mr. Chairman. Her name is Nina Olsen. I think she was with the Oversight Board, which was actively involved with working with us to recruit her, and she has a long background as not only a tax practitioner, but as a person who took the lead in establishing a network of low income tax clinics. She has got a lot of experience dealing with taxpayers with hardship, and that's one of the aspects of the taxpayer advocate service.

So, I think that we have really made some good progress here and have really put them in place to be, in effect, the safety valve that they need to be where you have a taxpayer who has either one of two things. Either they're not getting the service that they should, or they have a hardship that needs some special consideration, and I think that's working. We have, obviously, our challenges, there as in other places, defining exactly how they relate to the rest of the service. But, I really feel quite proud of what's been done there under the previous taxpayer advocate, Mr. Oberson, and now Nina Olsen, who I think is going to be an excellent leader for that organization.

Mr. HORN. I happen to have visited some of the ones in the West, and I was very impressed by them. My staff, I think I have told you this before, from my District Office, have had nothing but praise for your people at Laguna Niguel in terms of working with the various congressional offices in the region. We have hundreds of cases, all sorts of things, and they can't be resolved unless we've got good people at the other end of the bureaucratic line, and we've had no problems or anything. So, I congratulate you on putting the right people in the right place there.

Let me go back a minute on the business modification, and the Commissioner made a point there on how much money they can really absorb. What would be the General Accounting Office's views?

Mr. DACEY. Let me defer to Randy Hite, who can address that issue.

Mr. HITE. Mr. Chairman, our position on the funding of large modernization programs has always been that it's very difficult to estimate what it's going to cost to do many things over many years. Therefore, we have advocated an incremental approach to funding large modernization programs. The law has been set up with the ITIA account because, regardless of the amount that goes into the

ITIA account each year, in order for that money to be released, IRS must give an expenditure plan to the Appropriations Committees, and that plan needs to be reviewed and approved by Treasury, by OMB, and by GAO, and then we advise the Appropriations Committees on their decisions for release of that money.

So, having said that, the precise amount of money that they would be asking for in 2002 and 2003 is not that much of a concern to us. The expenditure plan is the means by which you manage the prudent and deliberate release of that money in relation to how it's going to be spent in the near term, but you can estimate with some precision.

Mr. HORN. I have one more question and then Mr. Putnam will wind it up. The question is how many of those browsers have been caught and what's happened to them? Have they been fired or what?

Mr. ROSSOTTI. That's the so called unauthorized access program, and we have, as a matter of fact, been very active working with the Inspector General for tax administration, expecially, on identifying those people, and our policy is, in fact, to terminate people if it's established that they have had a UNIX violation. We've been getting—and I've got the statistics here, I can give them to you more precisely if I can find them—approximately 200 cases that have been investigated. Some of those have been found after further investigation to be not——

Mr. HORN. In 1 year?

Mr. ROSSOTTI. This was for fiscal 2000, for last year. It was slightly less than—I'm just trying to find it. I've got so many statistics in here.

Mr. WILLIAMS. Mr. Commissioner, I have some data. I apologize for not telling you earlier.

Mr. ROSSOTTI. Go ahead.

Mr. WILLIAMS. Since the program began, 373 employees have been removed or resigned during the investigation for unauthorized access.

Mr. HORN. Any other comment on that?

Mr. ROSSOTTI. No. I was just trying to find the numbers. Thank you very much.

Mr. HORN. I yield to the gentleman from Florida for questions.

Mr. PUTNAM. Thank you, Mr. Chairman. I also am very concerned about this unauthorized access issue, and I'm curious to know if part of your modernization plan includes additional tools to detect this type of unauthorized access, and in addition to IRS employees viewing taxpayer records, I'm also concerned about the GAO report of serious weaknesses in the e-filing systems that allowed hackers to view, copy, and modify taxpayer data during the last filing season. What steps have you taken to prevent those occurrences from happening this filing season, and what is the long term solution to this?

Mr. ROSSOTTI. Well, as far as the issues identified by GAO in the last filing season, I do want to make clear that while those were important vulnerabilities, there was no evidence that there was anybody that actually got in and looked at any taxpayer—damaged any taxpayer data. I think GAO did an outstanding job of identifying some vulnerabilities that could have led to unauthorized access, but as far as we know—and of course there's always the possibility that something happened we didn't know—but we don't believe there was any unauthorized access from outside the IRS.

As far as what we've done about it, GAO came up with, I believe it was 59 specific recommendations or 56 that they gave to us last summer, as soon as they found some of these problems, and we acted very, very quickly to address those issues, and we addressed most of the—all the critical issues, that GAO indicated.

Now, GAO has not come back in to verify that yet, but we have certified our e-filing systems before this filing season with our own internal security office to make sure that we've actually followed through on those, and we are looking forward to getting GAO back in to verify that.

As far as the longer term is concerned, you asked the question, will the new architecture help us to identify, you know, unauthorized access of all kinds. The answer to that is yes, it will, and in two ways: One way is that right now we have a system that we work with Mr. Williams' staff on. We provide information to them from some of our systems, which allows them to run computer programs that identify possible cases of unauthorized access. They have a staff that is dedicated to doing that. It does an excellent job. When they find one of these cases they refer them to us for discipline, and that works reasonably well.

However, it has two limitations that we believe will be addressed in the new architecture. One of them is that it—just because we have 123 different systems right now that are not integrated, the ability to identify these possible accesses, you know, is not complete. It identifies them in the most common system, the most likely places they would occur, but it's not complete. So, there could be cases of unauthorized access that we currently don't identify just because of the limitations of our computing systems.

The other thing is that the tools we have to prevent the access in the first place are somewhat limited. In other words, the security controls that we have are there, but they're not as effective as they would be in the new environment. So, on both detection and prevention, we will have better capabilities in the new environment, and that is one of the most expensive pieces of the new architecture.

We have a whole project that is basically building a security architecture, a foundational issue, a foundational part of our architecture that is really aimed at providing robust security, and part of that, a major part of that, will be to prevent unauthorized access and to allow us to detect any attempts at unauthorized access. Maybe Mr. Williams might have some comments.

Mr. PUTNAM. In addition to the 383 that were engaged in the unauthorized browsing, how many instances of inappropriate use of information, illegal use of information, identity theft, how many instances of those sort have occurred among employees of the IRS?

Mr. WILLIAMS. If I may I'd like to provide you a more detailed written response, but essentially——

Mr. HORN. Without objection, it will be put in the record at this point.

Mr. WILLIAMS. Thank you, Mr. Chairman. We conduct about 4,000 investigations a year, and about half of those regard employees and half of those regard external employees. With regard to——

Mr. PUTNAM. External employees or external——

Mr. WILLIAMS. I'm sorry, external parties, and that's some sense to the number of investigations we do with—of all sorts of misconduct. The subset of unauthorized accesses and identity theft and the other kinds of disclosure issues that you raised, if I may, I'll provide.

Mr. PUTNAM. I will be very interested in that. People certainly ought to feel safe and secure in providing important information to the IRS and to any other government agency, and we ought to vigorously pursue anybody who would betray that trust.

Mr. WILLIAMS. Well, thank you. I appreciate your saying that. Of the employees that were involved in the access, some of those involved browsing. About 20 percent of those did involve disclosure or financial crimes, and that led to 65 criminal indictments in addition to the figures that I provided earlier to you.

Mr. PUTNAM. So, when we talk about browsing versus illegal use, they're just curious to know what a particular movie star or celebrity made? Is that the bulk of the browsing problems?

Mr. WILLIAMS. Those are the ones that are merely browsing. Probably the largest subset are relatives of the employees.

Mr. PUTNAM. I see.

Mr. WILLIAMS. There's also revenge as a motive when this very sensitive personal tax data is obtained. We've had instances in which it's been obtained for financial gain. There was one instance in which one of our seasonal employees actually did access a citizen's record, find out their address and other kinds of information regarding their lifestyle and habits, so that they could kill them. They were a witness to a crime that was committed.

Mr. PUTNAM. One final question, Mr. Chairman, if I may. Commissioner, I believe you indicated that you have about 20,000 seasonal employees?

Mr. ROSSOTTI. Actually, if you count everybody that works at all, it's probably closer to 30,000.

Mr. PUTNAM. How do you prepare these seasonal employees? How do you train them so that the answers that taxpayers receive are consistent, clear, and on message when you're dealing with a tax policy as complicated as we have?

Mr. ROSSOTTI. Mr. Putnam, you just put your finger on one of the hardest problems we have. I mean, we have a very complex—with respect to answering taxpayer's tax law questions. We have a very complex tax code. We have many different kinds of people that ask many different questions, and a high percentage of those kind of questions come in in a very short period of time, 3 months prior to the filing season. I'm not aware of anyplace else—I have looked around—I'm not aware of anyplace else—there are lots of other private sector companies that have, you know, lots of phone calls and some have seasonal, but our calls tend to be about three times as an indicator for an example of commercial calls. So, this is a major problem.

How are we dealing with it? Well, first of all, many of our seasonal employees actually return from year to year. This is an interesting thing, but we are actually able to retain—and this is one of our goals—seasonal employees. There are people who actually, because of their own personal situation, actually prefer not to work all year round, and we have been reasonably successful, at least for the people that deal with things like answering phone calls, we have a lot of seasonal employees that do mechanical tests like just key entry, sorting mail, and things like that, but for the more skilled ones they tend to be, and as much as possible, we get them to come back year after year, so they are not starting fresh the second time.

The second thing, of course, is that we do bring them in ahead of schedule so that they go through training before they go on to the filing system.

But, there is one thing that we are doing now, one very major thing that we are doing now, that we think will enable us even more—to do an even better job, especially on the quality, which is to rethink the entire way that these set of assisters are organized. We have about an average of 9,000 people answering phones on our toll free lines, but it gets up to almost twice that, or not quite twice, but well over that during the filing season, and in the past they had been managed through—they're in about 25 different locations. Each location had somewhat managed its work force kind of separately.

What we're doing now—this is a major part of our reorganization—is we are rethinking the entire network of all these 25 sites and rethinking from the point of view of what is the specialization of the particular kind of questions they can answer from simple to hard, how we can specialize these so that we will for any given question, people that are relatively less experienced answering the simple questions, then going up to people that know how to answer the more complex questions, so that we can—and using the new technology we will be able to route the calls all around the country to the person who has ideally just the right level of experience and specialization to answer these questions. This is a major part of the combination of our reorganization and our technology which is really a critical thing in terms of improving the quality.

Right today in the filing season, so far on tax law calls, about 75 percent, we have very a extensive system for monitoring these calls and about 74, well, 74½ percent of the tax law calls have been answered correctly. That's the other side of the 25 percent have not been answered correctly.

On the account calls, about 86 percent have been answered correctly. We have made some improvements on that through training, but the real strategy in the long term is to create this network of specialized assisters so that we will be able to get the right level of training, the right level of experience answering each type of question, and then route the calls to those people because that is really one of the hard problems we have to deal with.

Mr. PUTNAM. Thank you, Mr. Chairman.

Mr. HORN. On the seasonal worker problem, is there a problem in not giving them security checks, or do you treat hiring them just as you would hiring permanent employees?

Mr. ROSSOTTI. Well, that was a question—an issue that was identified by GAO a couple of years ago as a critical issue, fingerprinting and security checks, and in the past we did not, but we began this program actually in response to the GAO's recommendations about 2 years ago, and we have, I believe at this point, very close to 100 percent where they go through, even the people that work for a very short period of time.

I'd have to get you the numbers to know whether there were any exceptions that we may not have gotten 100 percent this filing season, but it is our goal to have 100 percent, and I think we've come close to it this year. I don't know—do you know whether we've gotten to 100 percent?

Mr. HORN. OK. What I'm going to do is the last question, I expect an answer from each of you. What are the three most important challenges facing the IRS in the next 3 to 5 years? Let's start over there with the Inspector General for tax administration.

Mr. WILLIAMS. Well, certainly the modernization, its successful completion and managing the ramp up that Mr. Levitan described to you. We also need to recover from the effects of both restructuring and modernization efforts which have been a tremendous drain. So, that brings me to the second, the drop in enforcement activity and rates; and the third is the continued efforts to raise customer service.

Mr. HORN. What's the gap that you see in the enforcement aspect? Do they not have enough personnel or they are not trained yet or what?

Mr. WILLIAMS. Enforcement levels have dropped seriously since 1996. They have dropped about 25 percent in the examination area, and about 39 percent in the collections area. In addition, that reduced force is being used to help on customer service problems when the IRS' normal work force becomes overwhelmed during this season. Another problem is the criminal enforcement group, the CI is migrating back into to its classic role that the Webster Commission recommended to it, and that it agreed to do. That migration has been a bit slow. They need to complete it. Then the modernization will provide a great deal of assistance in all areas, but enforcement is one of them.

Mr. HORN. Mr. Dacey, what do you feel—what's your two best shots in the next three—or the three most important challenges, whatever, in the next 3 to 5 years?

Mr. DACEY. I think in line with our testimony today there are really challenges in making sure the IRS gives the right information to the right people, that it is reliable, useful, and timely. I think that has a big effect on their ability to do their work and provide a level of service to the taxpayers that they demand. I think there are challenges in the short term in making sure they continue to manage those projects to ensure they deliver the promised value on time and in budget. In relation to that, their organizational transformation, or realignment, is highly dependent. Some of the long-term goals are highly dependent upon having that type of information. So, I think those are probably the biggest challenges. Those also have an impact on financial management and computer security, that have to be built into the processes that go forward.

Mr. HORN. How about you, Mr. Levitan, what do you and your colleagues think ought to be the three most important challenges?

Mr. LEVITAN. The three areas that must be addressed are modernization, customer service, and enforcement. Now, those really are in three separate areas. All of them are tied together and integrated. Modernization will provide the tools to completely reinvent how service is provided and how information is done, and so in the long term the way to solve the service and enforcement challenges is through effective implementation of the modernization program, and managing that program to success is by far the most important and the most difficult.

In the short term, service and enforcement can be improved with additional manpower, additional resources. Now, as I indicated earlier, that's not the long-term way to do it. That's kind of like sticking your finger in the dike, you know, to stop the immediate leaking, and in the long term, we've got to rebuild the dikes, and the bridges, and the roads, and all of that, and that's what modernization is about, and the focus on successfully managing modernization is absolutely critical.

Mr. HORN. Commissioner.

Mr. ROSSOTTI. I think we're all saying the same thing.

Mr. HORN. You want the chief financial officer to comment on this at all?

Mr. ROSSOTTI. Well, I'd like to ask him.

Mr. ROGERS. The issues that we're talking about here, and I think the Commissioner is going down this road and I agree with Mr. Levitan, is that it really is an integral piece, and from a personal standpoint as a retiree, if I might say so, I think the country really needs to make an investment in improving this agency, and that's going to mean money, and a little time, and a little faith in making this work.

From a financial management standpoint, I'd like to say that this year I think we made great strides. I'm very proud actually of the agency and what happened here, and I join Mr. Rossotti in thanking the GAO team. I think it was a team effort in bringing this about. We are planning the improvements for the coming year, and we think that when we appear here next year, we will have more good things to say about our improvements.

Mr. HORN. OK. Commissioner.

Mr. ROSSOTTI. Well, I think that we're all saying the same thing in slightly different ways, but let me try to just crystallize it in terms of how it looks when people are trying to manage it. I mean, I said that we have two tracks at the same time. We have to operate effectively and we have to modernize. In terms of the operating effectively part, there are significant opportunities over the next 2 years to improve the way we operate. That has to do with the area of our management team, our reorganization, and our performance measurements. The reason that we've made progress this year as compared with last year is really not due to modernization because it's just starting, and modernization in the technology sense of modernization. It has to do with our organizational and performance measures, and essentially what that boils down to, it's a whole new way of learning to run the organization.

You know, every manager from the ground up is learning how to manage in a way that balances customer service, compliance, you know, that looks at things on the basis of continuous improvement, all of those things, and I think we can make significant head way.

But, I believe we have an excellent management team in place and we have got a good plan, this plan which I gave to you, which says how to do that. That is one major challenge.

The other major challenge which everyone has noted is modernizing, and modernizing is not a technology project. I mean it is a technology project, but if it was only technology, we would be back into the same failures, you know, that we had previously. It really is a different way of doing business.

So, those two things together are the sort of the twin challenges. If you wanted to add a third one, which is a sleeper, I think one of the questions that—Mr. Putnam raised this—is that we have to renew our whole work force. You know, we have an aging work force. There's been nobody hired for years in the professional capacities. GAO's Mr. Walker has noted this as a problem across the whole Federal Government, but in the IRS, we are frankly at a dangerous point. I mean, there has been so little hiring for so many years that, you know, the art of actually bringing people into the organization and training them has virtually been lost. We're virtually starting up from scratch this year, and no matter how much you do with technology, you have to have skilled people in order to deal with taxpayers. I mean, you don't send out, you know, automatons to deal with taxpayers. You send people.

So, that's on top of everything else, and I think that fortunately the Congress did, in 2001, give us some resources, and we've begun to rebuild that, but it's not a 1-year project. It is not just adding people. It's just replacing the ones that we have. And so, when you add that to it, you've really got the three key dimensions which is learning how to manage in this new way effectively, modernizing, which means changing the way just about everything is done as well as putting in new technology, and rebuilding the work force. That's quite a bit to do.

Mr. HORN. Well, we wish you well. Let me thank the staff that prepared this hearing: J. Russell George, staff director, chief counsel sitting behind me; Diane Guensberg is a professional staff member on detail from the General Accounting Office; Bonnie Heald, director of communications; Earl Pierce, professional staff; Matthew Ebert, policy adviser; Grant Newman, assistant to the committee chair; Brian Hom, intern. And our minority staff is Michelle Ash, professional staff; Jean Gosa, minority clerk; and our two able court reporters are Julia Thomas and Melinda Walker. We thank you all for what you did, and gentlemen, we appreciate your coming. Let's see if we can't get a few private collectors to get that money. That's all I'm interested in. Thank you. The hearing is adjourned.

[Whereupon, at 4:55 p.m., the subcommittee was adjourned.]

[Additional information submitted for the hearing record follows:]

ONE HUNDRED SEVENTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON GOVERNMENT REFORM
2157 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515–6143

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April 4, 2001

The Honorable Stephen Horn
Chairman
Subcommittee on Government Efficiency, Financial
Management, and Intergovernmental Relations
Committee on Government Reform
B373 RHOB
Washington, D.C. 20515

Dear Chairman Horn:

Please make the enclosed letter and Commissioner Charles Rossotti's future response a part of the record for the April, 2, 2001 hearing of the Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations entitled, "IRS Progress in Addressing Management Issues."

I appreciate your prompt attention to this matter and if you have any questions, please feel free to contact me or Trey Henderson of my staff at (202) 226-5847.

Sincerely,

Jim Turner
Ranking Minority Member

JT:th
Enclosure

cc: The Honorable Charles Rossotti

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April 4, 2001

The Honorable Charles Rossotti
Internal Revenue Service
U.S. Department of the Treasury
Room 3241
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Rossotti:

As you may recall, in an attempt to address the problems the federal government has been experiencing with regard to its debt collection practices, I introduced H.R. 4181, the Debt Payment Incentive Act of 2000, during the 106th Congress. The bill amends the Debt Collection Improvement Act of 1996 to bar delinquent federal debtors, including tax debtors, from obtaining federal contracts, loans, and loan guarantees.

H.R. 4181, which originated in the House Government Reform Committee, enjoyed large bipartisan support and included both Chairman Dan Burton (R-IN) and Ranking Minority Member Henry Waxman (D-CA) as cosponsors. We were able to pass the bill out of the Committee by voice vote during the closing days of the last session of Congress but were unable to take further action due to time constraints.

I intend to reintroduce this legislation in the near future, and it is my hope to once again foster a bill which is supported by all stakeholders. The success of H.R. 4181 depends in large part on the Internal Revenue Service's (IRS) administrative capacity to identify delinquent federal taxpayers on a timely and reliable basis. When you testified before the Subcommittee on Government Management, Information, and Technology on April 10, 2000, the IRS was in the process of modernizing its systems and you expressed concerns about the large volume of transactions that H.R. 4181 might entail. In an effort to followup on this issue, I have asked Chairman Steve Horn (R-CA) to make the following questions and your answers a part of the Subcommittee's record for April 2, 2001:

1. Has the IRS successfully modernized its systems in order to administer on a timely and reliable basis the provisions of H.R. 4181? If not, when do you expect that the IRS will be able to do so?

2. In the future, will the IRS be able to identify delinquent federal taxpayers under H.R. 4181 on an instantaneous or "real time" basis?

3. What are the major impediments preventing the IRS from successfully administering H.R. 4181 and what steps are you taking to correct them?

4. Could the IRS successfully administer a limited, pilot program as referenced in H.R. 4181?

Enclosed is a copy of the legislation that passed out of the Committee as well as a summary for your review. I appreciate your prompt attention to this matter and look forward to your response. I also would like to commend you on your outstanding efforts to provide top-quality service to the American taxpayers. If you have any questions, please feel free to contact me or Trey Henderson of my staff at (202) 226-5847.

Sincerely,

Jim Turner

Jim Turner
Ranking Minority Member

JT:th

cc: The Honorable Stephen Horn